June 14, 2021

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Public Input on Climate Change Disclosures

Dear Secretary Countryman:

We are writing on behalf of the Consumer Federation of America (“CFA”)1 to provide our views in response to the Commission’s request for comment regarding climate change disclosures.2 We applaud the Commission for finally taking steps toward mandating disclosures regarding climate change and other critically important environmental, social, and governance (“ESG”) issues. Expanding the information that companies are required to provide about ESG issues, and improving the quality of that information, has been a high and growing priority for investors of all types and sizes for several years. Yet, while other countries have begun to take meaningful steps to respond to investor demand – and despite growing evidence regarding the threat issues such as climate change, racial injustice, and income inequality pose to the economy – the Commission has failed to act.3

We therefore welcome the current request for comment as a signal that the Commission plans finally to get off the sidelines and undertake a robust rulemaking agenda in this area. The goal of that rulemaking should be to ensure that investors have ready access to the comprehensive, comparable, and reliable information about ESG issues that they need to make fully informed capital allocation decisions, to manage their portfolio risks, and to engage effectively in the oversight of the companies whose shares they own. Taking these steps is not only well within the Commission’s authority, it is essential if the Commission is to fulfill its

1 CFA is a non-profit association of more than 250 national, state, and local pro-consumer organizations. It was formed in 1968 to advance the consumer interest through research, advocacy, and education. CFA Legal Intern Lincoln Plews assisted in the preparation of this letter.
3 We recognize the importance of the Commission’s publication of interpretative guidance in 2010 (Securities and Exchange Commission, Commission Guidance Regarding Disclosure Related to Climate Change (Feb. 8, 2010), https://www.sec.gov/rules/interp/2010/33-9106.pdf). We refer here to the subsequent inaction in the face of growing evidence that guidance alone was not sufficient.
public interest mission to protect investors, promote fair and orderly markets, and facilitate capital formation.

**Table of Contents**

I. CFA strongly supports Commission action to adopt mandatory ESG disclosure rules, including but not limited to climate change-related disclosures .................................................. 3
   A. Investors are demanding more and better ESG information ........................................... 4
   B. The data is important for regulators and other market stakeholders as well. ...................... 11
   C. The quality of current disclosures does not match investors’ reasonable expectations .... 16
   D. The Commission has not only the authority, but a responsibility, to act in response to investor demand .................................................................................................................. 18

II. Recommendations for Commission Action ........................................................................... 25
   A. Investors need better information with which to price climate-related risks and identify climate-related opportunities .................................................................................................................. 26
      1. Current climate change-related disclosures do not enable investors to properly price climate change-related risks .......................................................... 27
      2. The Commission should require disclosure of decision-useful information reflecting climate change-related risks and issuers’ exposure to these risks .............................................. 29
      3. Climate change disclosures should include explanations of risk management activities and scenario analyses ........................................................................................................ 32
      4. The SEC should look to existing data frameworks when determining the relevant, quantifiable climate change-related information to be disclosed ............................................. 34
   B. Material ESG disclosures should extend beyond climate change-related information .... 36
      1. The scope of material ESG information includes non-climate-related environmental practices and associated risks ........................................................................................................ 37
      2. The SEC may look to existing voluntary disclosure frameworks when identifying relevant environmental performance areas, but should not be constrained by them .......... 40
   C. Required disclosures should include relevant social and governance performance information .......................................................................................................................... 42
   D. Issuers should disclose quantitative and qualitative human capital management information because it is relevant and material to investors ................................................................. 44
      1. Recent efforts to elicit human capital management disclosures in Regulation S-K fall short of the needs and demands of investors ........................................................................ 46
      2. Existing voluntary ESG frameworks may help guide the Commission’s efforts to enhance human capital management disclosure rules ...................................................................... 48
      3. Diversity, equity, and inclusion information is particularly relevant and material to investors .......................................................................................................................... 49
E. The Commission should adopt a variation on the “COSO model,” with more stringent SEC oversight and support from an expert advisory panel, to review and update ESG disclosure rules.................................................................52

F. The Commission must take steps to ensure the reliability of any new ESG-related disclosures.................................................................61

G. The Commission should act to address “greenwashing” and “woke-washing.” ...............65

H. Other aspects of our regulatory framework needed to support effective ESG disclosures are in urgent need of repair.................................................................68

1. Audits of public companies need to be more independent and rigorous. .................68

2. Companies need to be accountable to shareholders regarding the accuracy of their disclosures..................................................................................71

3. The proxy process needs to be accessible to all investors, and investors need to be able to get reliable information on which to base their voting decisions. .......................72

4. With private markets having dramatically expanded, the Commission must act to ensure broader application of the disclosure requirements. ........................................73

I. CFA strongly supports Commission action to adopt mandatory ESG disclosure rules, including but not limited to climate change-related disclosures.

When Congress passed the Securities Act in 1933, it made clear that the fundamental purpose of the law is to ensure that investors receive “full disclosure of every essentially important element attending the issue of a new security.” Congress had witnessed the devastating impact that a “misdirection of the capital resources of the Nation” could have on its economy and its people. In delineating the types of information that would have to be provided, Congress sought to ensure that “no essentially important element attending the issue shall be concealed from the buying public.” The Securities Exchange Act adopted the following year added annual and periodic reporting requirements for companies whose shares traded in the secondary markets in order to ensure that investors continue to receive complete and accurate information when contemplating a trade and for as long as they hold the securities. This focus on transparency has been fundamental to the extraordinary success of our economy and investors, as well as the markets on which they depend.

Since those laws were adopted in the midst of the Great Depression, our understanding of exactly what constitutes an “essentially important element” that must be disclosed if investors are to be fully informed has evolved, as business, markets and the reasonable expectations of investors have changed. Never has that been more true than during the past year, when a worldwide pandemic, racial and political unrest, and a series of severe weather events have all

5 Id. at 2-3.
6 Id., The President’s Message at 2.
forced us to reevaluate what factors might impact a company’s financial prospects. That, in turn, has forced us to reevaluate what information should be required to be disclosed in support of informed investment decision-making. The question before the Commission now is whether these disclosure obligations should be updated to respond to a growing desire among investors for clearer, more complete, and comparable information on companies’ climate change-related risks and opportunities, and whether it also ought to include a broader spectrum of ESG factors on its rulemaking agenda. To both questions, we believe the clear answer is that the Commission can, and it must, act to bring our disclosure requirements into the 21st Century by incorporating a range of ESG factors into the disclosure framework.

Throughout this letter, we will use the ESG label to refer to a broad category of issues, most of which have not been captured by our current disclosure framework. In urging the Commission to develop improved mandatory ESG disclosures, we do not mean to imply that Commission rules need to address every issue that might be considered to be included within this category. Nor is it our intent to suggest that every ESG-related issue is equally material to investors or equally deserving of Commission attention. Instead, we use the ESG label as a convenience when discussing the issue more generally, while our recommendations below identify specific topics within the ESG universe of issues where we believe updating and mandating disclosures should be a priority.

A. Investors are demanding more and better ESG information.

The dramatic increase in interest among investors of all types in ESG factors, and the corresponding increase in demand for ESG information, is indisputable. A survey by Cerulli Associates found, for example, that 44% of 1,200 retail investor households surveyed said they preferred to invest in an environmentally or socially responsible way, and 80% of investors reported a preference for investing in companies that are leaders in environmentally responsible practices. Among households with investable assets between $100,000 and $250,000, 56% said they would rather invest in companies that have a positive social or economic impact. In the wake of the George Floyd murder, investor interest in racial justice investing initiatives is also reportedly surging. Further, a recent HSBC survey of two thousand investors and issuers revealed that “63% of investors in the Americas believe environmental and social considerations can improve performance and 71% feel a responsibility to consider environmental, social, and governance issues that might affect investment performance.”

---

7 See, e.g., Written testimony of Gregory Gelzinis, Associate Director for Economic Policy, Center for American Progress, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Hearing on 21st Century Economy: Protecting the Financial System from Risks Associated with Climate Change (Mar. 18, 2021), https://www.banking.senate.gov/imo/media/doc/Gelzinis%20Testimony%203-18-21.pdf. (“In just the past two years we’ve seen arguably the first climate bankruptcy in PG&E and witnessed energy companies, like BP and Total, write down the value of stranded assets, as energy price assumptions are re-calibrated.”)

8 Bernice Napach, How to Bridge the ESG Divide Between Advisors, Clients, ThinkAdvisor (Apr. 21, 2021), https://www.thinkadvisor.com/2021/04/21/how-to-bridge-the-esg-divide-between-advisors-clients/.

9 Id.


for ESG strategies is only anticipated to grow as Millennials and Generation Z come of age.\textsuperscript{12} Asked about anticipated demand for ESG strategies in the next two to three years, U.S. asset managers forecast high demand among 84% of Millennials and 70% of Generation Z, compared with just 8% of those 75 and older, 14% of Baby Boomers, and 34% of Generation X.\textsuperscript{13}

The same trend can be seen among institutional investors. For example, when the U.S. Government Accountability Office interviewed 14 institutional investors for a 2020 study on disclosure of ESG factors, 12 of the 14 said they seek information on ESG issues to better understand risks that could affect company financial performance over time.\textsuperscript{14} According to a survey by PwC, 72 percent of private equity investors and managers report that they “always screen potential portfolio companies for environmental, social and corporate governance risks and opportunities before making the investment.”\textsuperscript{15} More than a third of survey respondents (36%) said they consider climate change as part of their due diligence “to understand or mitigate the risk to portfolios.” And half of the 47% of survey respondents that said they do not currently measure the impact of climate change on portfolios, said they plan to do so in the next year.\textsuperscript{16} Similarly, a recently released Barclays survey of hedge fund managers found that 22% are “placing a high priority on ESG in their hedge fund allocation decisions – more than double the


\textsuperscript{13} Id.


\textsuperscript{15} Arleen Jacobius, \textit{ESG screening key for most private equity investors} – PwC, Pensions&Investments (May 14, 2021), \url{https://www.pionline.com/private-equity/esg-screening-key-most-private-equity-investors-pwc} \textit{[hereinafter P&I ESG Screening].}

\textsuperscript{16} Id.
year prior.” They found, moreover, that “investors with higher assets under management tend to prioritise ESG products when allocating to hedge funds.”

One manifestation of this growing interest in ESG data can be found in the rapid growth in the number of signatories to the United Nations Principles for Responsible Investment (PRI) since it was launched in 2006. Signatories commit to incorporating ESG issues into their investment analysis and ownership policies and practices. As of 2016, the principles had about 1,400 signatories with total assets under management of about $60 trillion. According to the 2020 PRI Annual Report, the number of signatories reached 3,038 as of last year. Nearly one-fifth of those (587) are located in the United States, an increase of 27% over the previous year. As SEC Commissioner Allison Herren Lee said in a 2020 speech, “There is really no historical precedent for the magnitude of the shift in investor focus that we’ve witnessed over the last decade toward the analysis and use of climate and other ESG risks and impacts in investment decision-making.

Consistent with ESG’s roots in the socially responsible and sustainable investing movements, some of that money is flowing into investments that specifically identify as sustainable or ESG investments. According to the US SIF Foundation’s biennial Trends Report, for example, $17 trillion – or one of every three dollars professionally managed in the U.S. today – is invested in sustainable investment strategies. In the United States alone, ESG-focused assets under management grew by roughly $5 trillion from 2018 to 2020, according to a recent PwC survey report. Meanwhile, Morningstar data indicates that “money flowing into U.S. mutual funds categorized as sustainable hit a record $51.1 billion last year, which is more than double the 2019 record of $21.4 billion.” This is a dramatic leap from the roughly $5 billion a year in annual flows into sustainable funds between 2013 and 2018, and the net outflows in 2011

18 Id.
21 Id.
and 2012.\textsuperscript{26} With Millennials projected to inherit $22 trillion over the next 25 years, that transfer of wealth can be expected to drive even greater demand for sustainable and ESG investments.\textsuperscript{27}

While the flow of funds to sustainable and ESG strategies is an important factor in the demand for better ESG disclosure, even more notable is the extent to which mainstream asset managers incorporate ESG factors into their basic investment due diligence. Commissioner Lee put it succinctly in a recent speech: “Not only have we seen a tremendous shift in capital towards ESG and sustainable investment strategies, but ESG risks and metrics now underpin many traditional investment analyses on investments of all types – a dynamic sometimes referred to as ‘ESG integration.’ In other words, ESG factors often represent a core risk management strategy for portfolio construction. That’s because investors, asset managers responsible for trillions in investments, issuers, lenders, credit rating agencies, analysts, index providers, and other financial market participants have observed their significance in terms of enterprise value. They have embraced sustainability factors and metrics as significant drivers in decision-making, capital allocation, and pricing.”\textsuperscript{29}

As the GAO found in its survey of institutional investors, “The use of ESG factors has emerged as a way for investors to capture information on potential risks and opportunities that otherwise may not be taken into account in financial analysis. ESG factors like climate change impacts and workplace safety may affect a company’s expected financial performance and thereby its value to shareholders.”\textsuperscript{30} All of the private asset managers interviewed and five of the seven public pension funds told GAO researchers they seek ESG information primarily “to enhance their understanding of risks that could affect companies’ value over time.” They indicated that they use ESG disclosures to monitor companies’ management of ESG risks, inform their vote at shareholder meetings, or make stock purchasing decisions.\textsuperscript{31}

\textsuperscript{26} Keeping ESG Performance in Perspective.
\textsuperscript{27} Cerulli White Paper.
\textsuperscript{30} GAO Report 2020.
\textsuperscript{31} Id.
In its survey of private equity funds, PwC found similar results. “Over the past seven
years, PE firms have radically reassessed the importance and value of ESG to their business.
It has gone from being considered a tangential area of compliance, or a specialist product for a
small minority of investors, to becoming an overarching framework that is informing the
strategic thinking of the entire firm.” PwC’s survey of general and limited partners from 209
firms found that “value creation” and “value protection” are top drivers of responsible
investment or ESG activity, identified as a top three driver by 66% and 40% of survey
respondents respectively. Just under half (49%) said they “integrate highly material ESG issues
into commercial due diligence when making investment decisions, albeit on an ad hoc basis.”
One reason for “this shift from risk mitigation to value creation,” according to PwC, “could be
that managing partners have come to realise that ESG offers a real business opportunity, and they
don’t want their firms to miss out.”

In short, the growing demand for better ESG disclosures is not being driven exclusively,
or even primarily, by a desire to create “a better, cleaner, well governed society,” but by the
needs of long-term investors to better understand investment risks and opportunities. Far from
being a threat to economic growth, investors of all stripes are increasingly concluding that
various ESG factors are critical to investment success. As the PwC report states, investors are
realizing that, “If we’re going to prevent further pandemics, reduce the risks of climate change,
build a more equitable society and still generate growth, it’s clear that we’ll have to create more
sustainable economies and systems.” (Emphasis added.) BlackRock, the world’s largest asset
manager with roughly $9 trillion in assets under management, put it this way in an ESG
Integration Statement updated in December: “As long-term investors, accounting for
environmental, social, and governance (ESG) risks and opportunities helps us provide
sustainable value to our clients.” Its Chairman and CEO, Larry Fink, has described the strategy
as “striving for more stable returns in the face of a fundamental reshaping of financial markets,
in which sustainability has become a critical factor in determining companies’ long-term
value.” State Street Global Advisors has stated that, “Quality data about companies’
Environmental, Social and Governance (ESG) practices is critical for effective analysis,” and
that, “The lack of standardization and transparency in ESG reporting and scoring presents major
challenges for investors.”

Investor demand for ESG information can also be seen in the large and growing number
of shareholder proposals related to ESG issues. As Commissioner Lee noted in a recent speech,
the shareholder proposal process is a key mechanism through which shareholders engage with

---

32 PwC Global Private Equity Responsible Investment Survey 2021.
33 Id.
34 Id.
35 See, e.g., Statement of SEC Commissioner Hester M. Peirce, Rethinking Global ESG Metrics (Apr. 14, 2021),
36 PwC Global Private Equity Responsible Investment Survey 2021
37 BlackRock, ESG Integration Statement (Effective Date: July 27, 2018, Revised: Dec. 8, 2020),
38 Id.
management of the companies they own.\textsuperscript{40} While governance-related proposals once dominated, “environmental and social proposals have been ascendant in recent years, making up more than half of all proposals filed in recent seasons.”\textsuperscript{41} This year is no exception. Shareholders have filed at least 435 resolutions on ESG issues for the 2021 proxy season, according to one analysis, including 136 climate-related resolutions.\textsuperscript{42} According to this analysis, social related proposals “remain quite broad ranging from lobbying to racial-justice resolutions,” including “proposals that seek third-party audits to see how companies are promoting racial equity in the workplace.” Several major asset managers have predicted an increase in proposals seeking disclosure of equal employment opportunity data.\textsuperscript{43} And more than 30 political and lobbying proposals have been filed.\textsuperscript{44} ESG considerations are also being incorporated into votes on board members.\textsuperscript{45} In a letter about its 2020 voting agenda, for example, State Street’s CEO announced its plans to “take action against the boards of companies that underperformed in ESG management.”\textsuperscript{46}

At the same time, there has been a significant increase in support for such proposals in the last decade. While support for environmental and social proposals held relatively steady over the first half of the past decade, it has grown rapidly since, as the table below illustrates.\textsuperscript{47} While just 36% of such proposals garnered at least 30% support in 2010 (and only 1% of those received at least 50% support), by 2020 the number garnering at least 30% support had risen to 83%, including 11% that received at least 50% support.\textsuperscript{48} One factor driving the increase in support is the change in voting practices among major private asset managers. BlackRock, for example, has reportedly gone from supporting just 6% of environmental proposals, 7% of social proposals, and 17% of governance proposals between July of 2019 and June of 2020, to supporting 91% of

\begin{footnotesize}
\begin{itemize}
  \item\textsuperscript{40} Remarks by Hon. Allison H. Lee, \textit{A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC}, (May 15, 2021), \url{https://www.sec.gov/news/speech/lee-climate-change} [hereinafter Commissioner Lee, A Climate for Change].
  \item\textsuperscript{41} \textit{Id.}
  \item\textsuperscript{43} \textit{Id.} (This year, Nuveen, the investing arm of TIAA, says it expects some 40 resolutions seeking EEO-1 disclosures, up from 22 last year. Sustainable investors, such as Calvert Research & Management, also are pushing companies to report EEO-1 data. The significant increase may be the result of Nasdaq’s proposed rule that would require listed companies to disclose statistics in a prescribed matrix format, and California’s legislation requiring board quotas based on racial and ethnic categories, and sexual orientation. For the most part, proposals in this category seek increased disclosure on diversity, equity, and inclusion initiatives, with many filed at companies that publicly supported the Black Lives Matter movement last year.)
  \item\textsuperscript{44} \textit{Id.; see also}, Catherine Boudreau, \textit{Public promises, private lobbying: Investors want clarity on corporate climate activity}, Politico (Apr. 20, 2021), \url{https://www.politico.com/newsletters/the-long-game/2021/04/20/public-promises-private-lobbying-492531}.
  \item\textsuperscript{45} \textit{Id.}
  \item\textsuperscript{47} \textit{Id.}
  \item\textsuperscript{48} \textit{Id.}
\end{itemize}
\end{footnotesize}
environmental proposals, 23% of social proposals, and 26% of corporate governance proposals in the subsequent one-year period.49

This growing shareholder support for ESG proposals has been on display during the most recent proxy season. In May, a proposal calling for General Electric to report on how it plans to achieve net-zero greenhouse gas emissions by 2050 was approved by 98% of shareholders after receiving backing by the company.50 At Phillips 66 a majority of shareholders approved a resolution calling for the company to set concrete emission-reduction targets, and a similar resolution for ConocoPhillips was approved by 58% of shareholders.51 A backer of the proposals explained it this way, “Big Oil can make or break the Paris Accord. Investors in oil companies are saying now: we want you to act by decreasing emissions.”52 Workforce diversity disclosure resolutions filed on behalf of three New York City pensions won overwhelming support at both DuPont (84%) and Union Pacific (86%), despite reported resistance from the companies in question.53

Meanwhile, asset management firms, public pension funds, trade union funds, faith-based institutions, family funds and endowments that are members of the Investor Alliance for Human Rights, an initiative of the Interfaith Center on Corporate Responsibility, are pressing companies to “do better when it comes to human rights.”54 While the current effort is focused on engagement to encourage companies to “be prepared to ‘know and show’ their potential [human rights] risks on an ongoing basis,” the effort will not stop there, according to its backers. “We are expecting companies to take action in response to this latest outreach, and if not, we are fully

49 Miller, 2021 Proxy Season Issues.
52 Id.
prepared to invoke the proxy process to motivate laggard companies,” explained one Alliance member.\(^{55}\)

Those two trends – a rising number of ESG-related proposals and rising shareholder support for those proposals – are expected to continue. In a recent article for the Harvard Law School Forum on Corporate Governance, for example, two Deloitte analysts noted that BlackRock CEO Larry Fink had “emphasized a focus on climate, specifically net-zero strategies, as well as on pertinent talent strategy elements such as diversity, equity, and inclusion” in his 2021 annual letter to CEOs.\(^{56}\) “Given this and similar statements, it is not surprising that in 2021, many investors have signaled plans to increase support for shareholder sustainability proposals,” they wrote.\(^{57}\)

Investors who seek to use the proxy proposal process “to improve corporate governance and advance sustainable long-term strategies at the businesses they own,” and shareholders who are asked to vote on such proposals, need good, reliable information about company practices on which to base those decisions.\(^{58}\) GAO found this to be the case in its survey of institutional investors. It reported that most investors it interviewed said they use ESG information “to inform their votes as shareholders at annual shareholder meetings, either through a proxy advisory firm or independently. Specifically, nine of 14 investors said that ESG information informs how they vote on directors’ nominations to the board and other proposals at public companies’ annual meetings.”\(^{59}\) It is no coincidence, however, that many of those proposals call for better company reporting around ESG issues, given the general consensus that current disclosures are not providing investors with the complete, comparable, and decision-useful information they need.

B. The data is important for regulators and other market stakeholders as well.

Investor demand is far from the only factor driving the call for more and better information about companies’ ESG risks, opportunities, and strategies. Other market participants – from regulators to financial institutions to credit rating agencies – are also driving demand. Much, though certainly not all, of this interest is related to climate change. For example, central banks are increasingly concerned that “rising sea levels, more wildfires and bigger storms could cause shortages that spur inflation, the regulators’ traditional nemesis.”\(^{60}\) In addition, they see potential risks to the financial system from climate change, including “losses on loans or a decline in the value of assets, such as waterfront property and property repeatedly exposed to

\(^{55}\) Id.


\(^{57}\) Sullivan and Bujno, Incorporating ESG Measures Into Executive Compensation Plans.

\(^{58}\) Commissioner Lee, *A Climate for Change*.


wildfires.” As such, they are among the many stakeholders, beyond investors, who are also increasingly reliant on ESG information.

Commercial banks, for example, “lend billions to companies that produce significant amounts of carbon dioxide, such as operators of coal power plants.” They also are in a position to invest in companies with products and strategies to address the climate crisis. Globally, 121 financial institutions with financial assets totaling $39.6 trillion have committed to measure and disclose the greenhouse gas emissions associated with their portfolio of loans and investments as members of the Partnership for Carbon Accounting Financials (PCAF). Among them are 19 financial institutions headquartered in the United States, including some of the nation’s leading commercial and investment banks and asset managers. In 2020, PCAF announced a new greenhouse gas accounting and reporting standard, which sets forth a methodology for financial institutions to measure financed emissions across six asset classes: listed equity and corporate bonds, business loans and unlisted equity, project finance, commercial real estate, mortgages, and motor vehicle loans. To follow this standard and fulfill their commitments, financial institutions will need good information on which to assess the greenhouse gas emissions of their portfolio companies. Similarly, financial institutions need information to help them understand the broader ESG-related risks and opportunities of the companies they finance, as do purchasers of the companies’ bonds and other debt instruments.

Credit rating agencies, which play an important role in assessing credit risk, reportedly increasingly take ESG factors into account when making those credit assessments. Moody’s Investors Service reported, for example, that ESG risks were a material consideration in 33% of Moody’s rating actions for private-sector issuers in 2019. While governance considerations were the most frequently cited ESG issue, the ESG issues cited in Moody’s 2019 rating actions “spanned all of the key categories of environmental, social and governance risk.” ESG risks are

61 Id.
62 See, e.g., Commissioner Lee, Playing the Long Game. (“Indeed investors, asset managers responsible for trillions in investments, issuers, lenders, credit rating agencies, analysts, index providers, stock exchanges and other financial market participants have embraced sustainability factors and metrics as significant drivers in decision-making, capital allocation, pricing and value assessments.”)
65 Id.
68 Id.
also increasingly a consideration for insurance companies.\textsuperscript{69} A recent report from Allianz Global Corporate & Specialty (AGCS) on key risks and loss trends for the financial services sector identified ESG among the top five risks. This goes beyond the well-recognized risks associated with increased flooding, wildfires, or extreme weather events. A recent “surge in regulation, in combination with inconsistent approaches across jurisdictions and a lack of data availability, represents significant operational and compliance challenges for financial service providers,” according to that report.\textsuperscript{70} (Emphasis added)

In short, one factor driving the demand for better climate-related disclosures is the “growing consensus that climate change may present a systemic risk to financial markets.”\textsuperscript{71} This concern is detailed in the recent report of the Climate-Related Market Risk Subcommittee of the Market Risk Advisory Committee of the Commodity Futures Trading Commission.\textsuperscript{72} The report was unanimously approved by the subcommittee’s 34 members, representing banks, asset managers, agribusiness, the oil and gas sector, academia and environmental organizations, providing strong evidence that this concern is widely acknowledged across virtually all segments of the economy in general and the financial system in particular.\textsuperscript{73}

In recent testimony before the Senate Banking Committee, Dr. Nathaniel Keohane, a member of the CFTC subcommittee, described the risks posed by climate change “to the financial system as a whole, as well as to specific types of financial institutions in particular sectors and regions.”\textsuperscript{74} At the macro, or systemic, level, “climate impacts could conceivably contribute to a financial crisis by propagating throughout the economy and undermining the value of financial assets, as previously hidden risks are suddenly taken into account,” he explained. Climate-related risks might also produce “‘subsystemic’ shocks, defined as those that affect financial markets or institutions, or a particular sector, asset class or region, but without threatening the stability of the financial system as a whole.”\textsuperscript{75} Financial institutions that hold assets that are particularly vulnerable to climate change – such as banks with international loan portfolios in climate-vulnerable regions, regional and community banks in

\begin{itemize}
\item \textsuperscript{70} Id.
\item \textsuperscript{71} Id.
\item \textsuperscript{73} Written testimony of Dr. Nathaniel Keohane, Environmental Defense Fund, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, \textit{Hearing on 21st Century Economy: Protecting the Financial System from Risks Associated with Climate Change} (Mar. 18, 2021), \url{https://www.banking.senate.gov/imo/media/doc/Keohane%20Testimony%203-18-21.pdf} [hereinafter Keohane Senate Banking Committee testimony].
\item \textsuperscript{74} Id.
\item \textsuperscript{75} Id.
\end{itemize}
coastal areas and other climate-vulnerable regions, and agricultural banks – could be at particular risk, he noted.\textsuperscript{76}

While some institutions may be at particular risk, climate change “also poses a systemic threat due to the potential magnitude of the physical and transition-related risks, the wide array of financial institutions and markets exposed to these risks, and the speed with which these possibly correlated risks could materialize.”\textsuperscript{77} Experts have warned that, in a worst-case scenario, “continued complacency could lead to a ‘climate bubble’ that, upon bursting, would send shockwaves through the economy, resulting in another financial crisis on the scale of the Great Recession.”\textsuperscript{78}

Commissioner Lee described how such a scenario might unfold in a recent speech\textsuperscript{79} She noted that “[s]ystemic shocks are more likely when asset prices don’t fully incorporate the relevant risks,” leading to underpricing of those risks, as currently appears to be the case with physical, transition, and liability risks related to climate change. “Underpricing can lead to abrupt and disruptive re-pricing as markets discover the anomalies,” she added, which “could be triggered by massive climate-related events or significant changes in legal requirements that can render assets and even business models obsolete in a very short timeframe.” Researchers at the Bank for International Settlements have referred to this type of systemic risk as a “green swan” event, warning that it could have potentially irreversible effects.\textsuperscript{80} Faced with such a potential, regulators must have good data on which to assess the risks to the financial system and the economy as a whole.

The lack of disclosure intensifies the risk by increasing uncertainty, Keohane warned in his Senate testimony. A range of scenarios for how climate change could threaten the U.S. financial system are possible, “but we don’t know when or how those scenarios could occur – because we are not requiring businesses and financial institutions to assess, measure, manage, and disclose those risks.”\textsuperscript{81} This creates problems for financial regulators, including but not limited to the SEC. “[M]arket efficiency and integrity can only be maintained when market participants are aware of climate risks to regulated entities and investments; taxpayer losses can only be prevented when the effects of climate change are considered; and financial stability can only be maintained when systemic risks like climate change are proactively addressed. More generally, risk identification, reduction, and allocation guide regulatory oversight and should extend to consideration of climate impacts.”\textsuperscript{82} For that to happen,

\textsuperscript{76} Id.
\textsuperscript{77} Written testimony of Gregory Gelzinis, Associate Director for Economic Policy, Center for American Progress, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Hearing on \textit{21st Century Economy: Protecting the Financial System from Risks Associated with Climate Change} (Mar. 18, 2021), \url{https://www.banking.senate.gov/imo/media/doc/Gelzinis%20Testimony%203-18-21.pdf}.
\textsuperscript{79} Commissioner Lee, \textit{Playing the Long Game}.
\textsuperscript{80} Id.
\textsuperscript{81} Keohane Senate Banking Committee testimony.
\textsuperscript{82} Id.
however, regulators need access to the kind of data that would come from improved mandatory ESG disclosure.

The lack of comprehensive ESG reporting may also pose risks to companies themselves. As authors of a paper by NYU Institute for Policy Integrity and Environmental Defense Fund (EDF) explained, “managers and directors of companies will often make decisions based on incomplete information and imperfect heuristics about the risks that they face. Other structural issues may additionally obstruct full and accurate accounting of risk. Managers and directors may have, for example, short-term incentives to boost quarterly earnings and share prices. Taken together, cognitive biases and mismatched incentives can result in managers underestimating or failing to foresee the risks that climate change poses for the long-term fiscal well-being of their companies. This lack of foresight will leave corporations unprepared to adapt to the rapidly changing climate and the regulatory environment that comes with it.”

While these authors are focused specifically on climate-related risks, the same logic applies to risks related to other ESG factors, such as racial justice, worker rights, and political activity, as events of the past year have helped to illustrate.

According to the NYU and EDF authors, “Improved mandatory disclosures could force corporations to engage in careful and systematic analyses of their exposures to climate risk, preventing them from ignoring worst-case scenarios or unfavorable information.” Improved mandatory disclosure would also help to address a collective action problem, in which managers motivated “to keep share price and credit ratings high” may be reluctant to disclose potentially unfavorable climate risk information “if it will lead investors to favor competing corporations” that are not making such disclosures. But, if everyone is required to disclose, “Corporate managers can benefit from information sharing, while avoiding the penalties and backlash that may have come with unilateral disclosure.” Here again, the same logic applies to other ESG issues.

Companies across a variety of sectors, including the financial sector, have started to respond to these developments. Over the past 25 years, there has been “exponential growth in the number of companies measuring and reporting environmental (i.e. carbon emissions, water consumption, waste generation, etc.), social (i.e. employee, product, customer related, etc.), and governance (i.e. political lobbying, anti-corruption, board diversity, etc.) data, collectively ESG data,” according to one academic study on investors’ use of ESG information.

While fewer than 20 companies disclosed ESG data in the early 1990s, the number of companies issuing sustainability or integrated reports had increased to nearly 9,000 by 2016, according to that analysis. As the Deloitte analysts explained, “Many companies now recognize that developing and implementing an ESG strategy is more the norm than an exception” and, as a result, they are

84 Id.
85 Condon et al., supra.
“evaluating how best to demonstrate progress through robust measures and enhanced disclosures.” In short, issuers need to be able to show their progress in a way that will enable investors to compare them to their peers. In turn, the many companies that have responded to recent events with public statements about their commitment to net-zero emissions, diversity and inclusion, or political spending should expect to be held accountable by shareholders for their actions to achieve those goals. Investors need better information to assess those claims. As a result, the demand for improved mandatory disclosures to support that accountability can be expected to grow.

C. The quality of current disclosures does not match investors’ reasonable expectations.

Currently, issuer disclosures relating to climate-related risks, opportunities, and metrics are issued voluntarily, and are therefore profoundly inconsistent, both in form and quality. This shortcoming has been pointed out by a variety of investors and other users of the information. In a 2014 letter to the SEC, for example, Lisa Woll of the US Sustainable Investment Forum stated that “investor efforts to comprehensively incorporate ESG information into investment decisions have been hindered by a lack of comprehensive, comparable and reliable data. The primarily voluntary nature of corporate sustainability reporting means that the information available to investors remains inconsistent and incomplete.”88 With regard to climate risks, where Commission policy has for more than a decade required companies to disclose material risks, an analysis by Ceres of disclosures of the 600 largest U.S. companies found that “more than half… still don’t provide decision-useful disclosures on climate-related risks. Those that do often provide disclosures that are mere boilerplate, or too brief, and therefore effectively meaningless.”89

Even as the focus on ESG has grown dramatically in recent years, little has changed in terms of the quality of disclosures available to support that focus. In its interviews with institutional investors, for example, GAO found that most seek out additional ESG disclosures from companies “to address gaps and inconsistencies in companies’ disclosures that limit their usefulness.”90 In its own review of companies’ ESG disclosures, GAO found that, while most companies provided information related to ESG risks or opportunities that was specific to the company, some did not. It found, moreover, that “differences in methods and measures companies used to disclose quantitative information may make it difficult to compare across

---

87 Sullivan and Bujno, Incorporating ESG Measures Into Executive Compensation Plans.
89 Ceres, Requiring disclosure of climate change risks makes sense for investors, companies, and the U.S. economy (July 17, 2010), https://www.ceres.org/news-center/blog/requiring-disclosure-climate-change-risks-makes-sense-investors-companies-and-us. See also, Parker Bolstad et al., Flying Blind: What Do Investors Really Know About Climate Change Risks in the U.S. Equity and Municipal Debt Markets?, Hutchins Center Working Paper #67 (Sept. 2020), https://www.brookings.edu/wp-content/uploads/2020/09/WP67_Victor-et-al.pdf. (“60% of publicly traded firms reveal at least something about climate change, but the largest volumes of information are skewed heavily toward a few industries (e.g., electric utilities, oil & gas, mining) and concern valuation risks due to possible transition away from fossil fuels. By contrast, there is much less disclosure around the physical risks of climate change.”)
90 GAO Report 2020
companies,” citing differences in how companies report carbon dioxide emissions as an example. Even those involved in developing the voluntary disclosures have acknowledged the issue. The most recent report of the Task Force on Climate-related Financial Disclosures (TCFD), for example, indicates that although support for TCFD continues to grow, “companies’ disclosure of the potential financial impact of climate change on their businesses and strategies remains low.” When companies’ disclosures are inconsistent and incomplete, that imposes significant costs on investors to seek out the additional information they need, and additional costs on companies to respond to those requests.

In his recent Senate testimony, EDF’s Keohane described shortcomings with regard to climate change-related disclosures in greater detail. “Although climate related financial risks are growing, current disclosure regimes in the United States have not kept pace. SEC guidance in 2010 was important and pathbreaking but has proven insufficient, with resulting disclosures **lacking in specificity, submitted with boilerplate language, or missing entirely.**” (Emphasis added.) Voluntary standards and frameworks have emerged, including those from TCFD and the Sustainability Accounting Standards Board (SASB), and they “have been critical to advancing climate risk disclosure,” according to Keohane, but “they are insufficient. Recent study has found that although climate risk disclosure has increased, ‘[m]ore firms are disclosing more general information that is essentially of no utility to the marketplace.’ In addition, disclosure varies across sectors and some sectors that are particularly vulnerable to climate impacts, such as agriculture, are lagging in their assessment and disclosure of climate risks.”

For both investors and issuers, inconsistent material climate change-related information limits capacities to effectively allocate capital, develop long-term corporate finance and investment strategies, manage financial risks and risk exposure, and realize climate related opportunities. In a nutshell, inconsistent material information exacerbates market entropy and diminishes the reliability of domestic capital markets. This information gap was discussed in a 2019 article on ESG data challenges by State Street Global Advisors. The article highlighted the inherent problems with available ESG data, stating, “Quality data is the lifeblood of investment analysis. While ‘quality’ can be defined in several ways, most investors agree that consistency and comparability in the availability of data across companies are essential elements of an effective data set. Unfortunately, the current landscape provides headwinds to achieving those elements of quality when it comes to data about a company’s ESG practices. […] Companies are

---

91 Id.
93 See, e.g., Speech, SEC Commissioner Hester M. Peirce, Scarlet Letters: Remarks before the American Enterprise Institute (Jun. 18, 2019), https://www.sec.gov/news/speech/speech-peirce-061819. (“A senior counsel from a major insurance company reported her experience at a recent Investor Advisory Committee meeting at the SEC. Her company received approximately 55 survey and data verification requests from ESG rating organizations in the last year. By her company’s estimate, it took 30 employees and 44.8 work days to respond to just one of these surveys. While this is just one company’s experience with one survey, one could expect that some surveys will go unanswered because of lack of corporate resources.”)
94 Keohane Senate Banking Committee testimony.
left to determine for themselves which ESG factors are material to their business performance and what information to disclose to investors.”

As the Federal Reserve Board recently pointed out, inconsistencies in data also create inequities for market participants, with smaller investors, companies, and institutions at a particular disadvantage. “Although the public sector generates a range of weather and climate data, much of that data resides across agencies and jurisdictions, leaving researchers to clean, process, and merge the data separately and independently,” the Fed explained. “Once a data set is complete, analysis may be especially computationally intensive, requiring expertise and resources beyond the reach of many smaller research institutions. Several private firms have launched services to fill this gap, focusing on geographic exposures to more severe weather events, but generally remain available only to those who purchase them.”

In light of these concerns, many investors and other stakeholders have called for improved climate-related disclosures. In their paper, for example, NYU and EDF researchers argued that, “New regulations are needed that will bring the quality of climate risk disclosures level with other forms of risk disclosure commonly required of publicly traded companies. The SEC, as the primary regulator of American securities markets, should mandate that publicly traded companies disclose their climate risk in a manner that is comparable, specific, and decision-useful.” We agree. Moreover, while many have expressed similar concerns related to the inadequacy of climate-related disclosures, investors’ interest in ESG information is not limited to climate. And the problems of incomplete and inconsistent disclosures may be even more evident outside the climate change context, as we discuss in greater detail below. That incomplete and inconsistent information may then be incorporated into ESG ratings and indexes that drive significant capital flow, rendering them less reliable. Improved mandatory disclosures are essential to resolve these information gaps and inconsistencies.

D. The Commission has not only the authority, but a responsibility, to act in response to investor demand.

Some have questioned not only the necessity of adopting mandatory ESG disclosures, but also the Commission’s authority to do so. Among members of Congress, Sen. Pat Toomey has been particularly vocal in expressing this view, stating for example that SEC action to mandate

97 Condon et al., Mandating Disclosure of Climate-Related Risk.
98 Sakis Kotsantonis and George Serafeim, Four Things No One Will Tell You About ESG Data, 31 Journal of Applied Corporate Finance 50 (Spring 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3420297&download=yes. (The report focuses in part on the “sheer variety, and inconsistency” of ESG data and measures and of how companies report them. For example, it lists more than 20 different ways companies report their employee health and safety data.)
99 Id. (“The differences in the imputation methods used by ESG researchers and analysts to deal with vast ‘data gaps’ that span ranges of companies and time periods for different ESG metrics can cause large ‘disagreements’ among the providers, with different gap-filling approaches leading to big discrepancies.”)
ESG disclosures “would be a total abuse of power and a politicization of SEC’s disclosure standard. What matters is whether an issue is financially material to a reasonable investor, not if it conforms to the woke Left’s opinion about what’s best for humanity’s general welfare.” Among other things, Sen. Toomey has objected to a recent announcement that the Commission would be looking at possible enforcement actions based on the principles-based requirement, articulated in the agency’s 2010 staff guidance, that companies disclose material climate-related risks. Sen. Toomey suggested that enforcing the decade-old requirement would be “premature,” since the guidance is currently undergoing review. He is not alone in expressing these concerns. Among others, both Commissioner Hester M. Peirce and Commissioner Elad Roisman have articulated similar objections.

The prevailing argument against mandatory ESG disclosures starts from the premise that disclosures should be based on what investors view as material, a point on which we generally agree. But it then ignores overwhelming evidence that investors do in fact view a number of ESG-related issues, including with regard to climate change, as material to both their investing and voting decisions. As we detail above, many institutional investors consider ESG factors, not just as a part of an ESG strategy, but as essential elements in their analysis of both value protection and value creation. And they have voiced frustration that current disclosures often don’t provide the decision-useful information they need to support that analysis. The argument

---


103 See, e.g., Coingeek, Hester Peirce on SEC’s ESG policy direction under new chair (May 10, 2021), https://coingeek.com/chester-peirce-on-secs-esg-policy-direction-under-new-chair/; “(We have a principles-based disclosure framework that is rooted in materiality and intended to be flexible so it can be used by issuers across industries. The materiality standard is derived from U.S. Supreme Court case law, which tells us that information is material if there’s a substantial likelihood that a reasonable investor would consider the information important in making a financial decision about the company. That’s an objective test that we can look at.)”


105 See pages 5-8.

106 See pages 16-18.
also seems to assume that the only valid motivation for investors is to maximize returns – and that therefore the only legitimate justification for ESG investing is if it delivers superior returns\(^\text{107}\) – ignoring legitimate reasons why “reasonable” investors might also want to ensure that their investments reflect their values or don’t contribute to the environmental degradation of the planet. Moreover, the argument against ESG disclosure mandates often assumes, without evidence, that companies are already fully disclosing any material climate-related risks in response to the 2010 staff guidance, even as proponents of this view caution against enforcement of that guidance.\(^\text{108}\)

Fundamental to each of these arguments is the idea that mandating ESG disclosures would require the SEC to “reimagine materiality” in a way that would ultimately prove harmful to investors.\(^\text{109}\) In reality, however, it is the purveyors of this argument who appear to be redefining materiality in order to support their claim that ESG disclosures have no place in a materiality-based disclosure regime. First, it is simply not the case that disclosure requirements for issuers under the federal securities laws are limited to those that are financially material. As Commissioner Lee stated in a recent speech, Section 7 of the Securities Act “gives the SEC full rulemaking authority to require disclosures in the public interest and for the protection of investors,” and neither that authority, nor the Commission’s separate authority under Sections 12, 13, and 15 of the Securities and Exchange Act to require periodic reporting, “is qualified by materiality.”\(^\text{110}\) Indeed, there are a number of areas where Commission rules require companies to make specific disclosures, regardless of whether they are financially material, including with regard to related party transactions, illegal acts, and internal controls. Thus, while some matters are required to be disclosed only when material, others are required of all public companies, regardless of whether they are financially material on a company-by-company basis.

\(^{107}\) See, e.g., Commissioner Peirce, Scarlet Letters. (“It is true that ESG issues may well be relevant to a company’s long-term financial value. At a recent hearing before the Senate Banking Committee, John Streur of Calvert Research and Management testified that it is a ‘misconception’ that using ESG investment strategies results in the investor sacrificing returns. In fact, he said, research has found that ‘firms in the top quintile of performance on financially material ESG issues significantly outperformed those in the bottom quintile.’ Why, then, must the word “ESG” must be used at all? Of course, firms in the top quintile of performance on financially material issues outperform those on the bottom. If ESG disclosures mean disclosing what is financially material, there is little controversy, but the ESG tent seems to house a shifting set of trendy issues of the day, many of which are not material to investors, even if they are the subject of popular discourse.”)

\(^{108}\) Statement of Commissioners Peirce and Roisman, Enhancing Focus. (“Wouldn’t it be more prudent for us to await the results of the Corporation Finance staff’s latest review of climate change-related disclosure and the Examinations staff’s climate- or ESG-related findings in this new exam cycle before allocating resources to an ESG-specific Enforcement initiative? Better yet, shouldn’t we wait for our Corporation Finance staff to complete its assessment of our existing rules relating to ESG disclosures to find out if they are unclear or in need of updating before we announce an initiative aimed at bringing enforcement actions in this area?”)

\(^{109}\) SEC Commissioner Hester M. Peirce, Rethinking Global ESG Metrics (Apr. 14, 2021), https://www.sec.gov/news/public-statement/rethinking-global-ESG-metrics. (“To get to broad ESG disclosure mandates for issuers, we have to reimagine materiality. But reimagining materiality is the same as tossing it in favor of a more malleable new edition. Materiality has served us well, and undermining it to accommodate ESG will harm investors.”)

Those who seek to limit disclosures to only those factors that are “appropriate to be considered by every company across every industry” appear to be misinterpreting both the Commission’s broad authority and the traditional application of materiality considerations to company disclosures.\footnote{111} We agree with Commissioner Lee, moreover, that adoption of such an “artificially circumscribed … item-by-item, and company-by-company, analysis of materiality” would not only be inconsistent with the Commission’s, courts’, and Congress’s interpretation of the securities laws, it would also seriously undermine investors’ ability to make comparisons among companies based on those disclosures.\footnote{112} Some have sought to dismiss the importance of comparability in our disclosure system.\footnote{113} As Commissioner Lee pointed out in her speech, however, “modern capital markets … have become increasingly comparative in nature.”\footnote{114} Reducing disclosure mandates to those topics that are material to all companies, and relying on general materiality for the rest, would inhibit the ability of investors to allocate their capital to its best uses, thus undermining one of the fundamental purposes of the federal securities laws.

Second, materiality is not measured exclusively by its impact on a company’s bottom line. In \textit{Basic v. Levinson}, the Supreme Court held that “materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information.”\footnote{115} The Court had previously held, in \textit{TSC Industries, Inc. v. Northway, Inc.}, that, for a matter to be material, “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”\footnote{116} The Court made clear, moreover, that such determinations do not “require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote,” but instead “contemplates a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the reasonable shareholder’s deliberations.”\footnote{117}

Those who argue that ESG disclosures don’t fit within this Supreme Court definition of materiality seem to assume that the only matters of interest to a “reasonable shareholder” are those that have an immediate and substantial impact on the company’s bottom line. In 1999, the

\begin{footnotes}
\item[111] Patrick Donachie, \textit{Commissioner Peirce Says SEC Must Play Part in Any ESG Enforcement ‘Sea Change’}, WealthManagement.com (Mar. 5, 2021), \url{https://www.wealthmanagement.com/regulation-compliance/commissioner-peirce-says-sec-must-play-part-any-esg-enforcement-sea-change}. (“It takes a lot for me to think that we need to get to the point of having very specific disclosure mandates for anything,” [Commissioner Peirce] said. “I’m open to those conversations, and certainly open to hearing why a particular metric might be appropriate to be considered by every company across every industry, but I think that’s a pretty high bar to meet.”)
\item[112] \textit{Id.} (“Moreover, if SEC disclosure rulemaking authority were artificially circumscribed by both an item-by-item, and company-by-company, analysis of materiality, comparability would be sacrificed almost completely. Indeed such an approach would be at odds with modern capital markets which have become increasingly comparative in nature thus requiring at least some specific metrics in order to make appropriate comparisons.”)
\item[113] SEC Commissioner Elad L. Roisman, \textit{An Honest Conversation about ESG Regulation} (Mar, 19, 2021), \url{https://www.sec.gov/news/speech/roisman-amac-2021-03-19}. (“To the extent that you are looking to increase comparability of issuers’ disclosure, why is this important in the case of ESG? In other contexts, we do not demand perfect comparability across all categories of material information.”)
\item[114] Commissioner Lee, \textit{Material World}.
\item[117] \textit{Id.} at 444-449.
\end{footnotes}
Commission released a staff accounting bulletin dealing with materiality in part to rebut just such assumptions. The concern at the time was the reliance on certain quantitative benchmarks to assess materiality in the preparation and auditing of financial statements.118 Specifically, SAB 99 asks whether a registrant or the auditor of its financial statements can “assume the immateriality of items that fall below a percentage threshold set by management or the auditor to determine whether amounts and items are material to the financial statements.” The answer provided is an unequivocal, “No.” The staff bulletin goes on to explain that “exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law.”119

Instead, SAB 99 directs preparers and auditors of financial statements to “consider both ‘quantitative’ and ‘qualitative’ factors in assessing an item’s materiality,” and notes that “[q]ualitative factors may cause misstatements of quantitatively small amounts to be material.”120 That concept has been tested in court and upheld.121 SAB 99 further notes that, while expected market reaction is relevant to a consideration of materiality, “Consideration of potential market reaction to disclosure of a misstatement is by itself ‘too blunt an instrument to be depended on’ in considering whether a fact is material.”122 In other words, while something that would be expected to have a significant impact on the stock price would almost certainly be considered to be material, it does not follow that something that is expected to have little if any impact on the stock price would not be considered material. Of course, context matters when it comes to materiality, and this guidance was developed to address considerations regarding materiality as that concept relates to financial misstatements. It nonetheless helps to illustrate just how inconsistent it is with the long-standing views of the SEC, FASB, and the courts to suggest that only those matters that are likely to have an immediate and sizable impact on company finances or performance are material to reasonable investors.

In short, in deciding what ESG-related information must be disclosed, the Commission should not be limited by this mistaken interpretation of materiality. Taken to an extreme, such a limited view of materiality based on its immediate impact on company finances and performance could end up encouraging the lack of long-term thinking that many, including former SEC Chair Jay Clayton, have decried.123 After all, one reason so many investors appear to be focused on

119 Id.
120 Id.
121 Ganino v. Citizens Utilities Co., 228 F.3d 154 (2d Cir. 2000), at 163-64 (“[B]ecause SEC staff accounting bulletins ‘constitute a body of experience and informed judgment,’ and SAB No. 99 is thoroughly reasoned and consistent with existing law – its non-exhaustive list of factors is simply an application of the well-established Basic analysis to misrepresentations of financial results – we find it persuasive guidance for evaluating the materiality of an alleged misrepresentation.” (internal citation omitted)) See, also, Litwin v. Blackstone Grp., L.P., 634 F.3d 706, 717 (2d Cir. 2011) (“In both Ganino and ECA & Local 134, we cited with approval SEC Staff Accounting Bulletin No. 99, 64 Fed.Reg. 45,150 (1999) [hereinafter SAB No. 99], which provides relevant guidance regarding the proper assessment of materiality. See ECA & Local 134, 553 F.3d at 197–98; Ganino, 228 F.3d at 163–64.”)
122 Id.
123 See, e.g., Eve Tahmicioglu, SEC Chief Takes on Short-Termism and ESG, Directors&Boards, https://www.directorsandboards.com/articles/single/sec-chief-takes-short-termism-and-esg, (“If by short-termism you mean companies, in response to market and other pressures, pursuing short-term objectives to the detriment of long-term performance, it bothers me. It principally bothers me because that type of short-term perspective generally is
climate change in their assessment of investment risk and opportunities is their belief that the physical, transition, and liability risks associated with climate change pose serious long-term threats, but also offer long-term opportunities to those who devise effective products and strategies to meet that threat. In order to decide how best to allocate their capital, whether to buy, hold or sell a company’s shares, and how to vote their proxies, investors who hold these views need information about companies’ plans related to climate change and the potential cost of those plans. The fact that other investors don’t hold these views, or might choose to act differently based on that information, doesn’t make it “unreasonable” for investors to demand improved mandatory disclosure of climate change-related information.

Another argument put forward against mandatory ESG disclosures is that companies are already fully disclosing any information related to climate change or other ESG issues that is material to their business. This is not a safe assumption even where, as is the case with climate risks, the Commission has issued staff guidance directing companies to disclose their material climate risks. As Commissioner Lee noted in her recent speech, “a principles-based standard that broadly requires disclosure of ‘material’ information presupposes that managers, including their lawyers, accountants, and auditors, will get the materiality determination right. In fact, they often do not.” Corporate executives are not disinterested arbiters of whether something is material to investors. They have an incentive to paint things in the most positive light, and thus may be inclined to under-estimate and understate risks.

In other areas even this principles-based guidance is absent and thus no obligation to disclose the information exists, no matter how important or financially relevant the information may be to investors. Contrary to common misconception, there is no overarching obligation under the securities laws for companies to disclose all material information. Instead, the duty to disclose arises where there is either a specific mandate to disclose under securities laws or regulations or where the disclosure is necessary to render other statements not misleading. For

inconsistent with the investment objectives of our Main Street investors. In addition, if our public capital markets are overly short-term focused, that perspective may undermine capital formation in our public markets.”) See also, Roger L. Martin, Yes, Short-Termism Really Is a Problem, Harvard Business Review (Oct. 9, 2015), https://hbr.org/2015/10/yes-short-termism-really-is-a-problem.


125 Commissioner Lee, Material World.

126 Condon et al., Mandating Disclosure of Climate-Related Risk. (“Taken together, cognitive biases and mismatched incentives can result in managers underestimating or failing to foresee the risks that climate change poses for the long-term fiscal well-being of their companies.”)

127 Marc I. Steinberg and Robin M. Goldman, Issuer Affirmative Disclosure Obligations – An Analytical Framework for Merger Negotiations, Soft Information, and Bad News, 46 Md. L. Rev. 923, 923-24 (1987) (“Despite cogent arguments in favor of an affirmative duty to disclose, neither the courts nor the SEC has been willing to recognize such a general mandate.”) See also, Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 44 (2011) (“Moreover, it bears emphasis that §10(b) and Rule 10b-5(b) do not create an affirmative duty to disclose any and all material information. Disclosure is required under these provisions only when necessary ‘to make . . . statements made, in the light of the circumstances under which they were made, not misleading.’”); In re Time Warner Inc. Sec. Litig., 9 F.3d 259, 267 (2d Cir. 1993) (“[A] corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact. Rather, an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts.”).
most ESG-related issues, no such mandate currently exists. Thus, the reason most ESG reporting today occurs outside the financial statements is not because the information has been deemed not to be material, but because there is no explicit disclosure obligation covering the issue.

Finally, those who argue that ESG disclosures aren’t material ignore the fact that ESG considerations are already having a significant impact on companies’ ability to raise capital and their cost of capital. Investors must consider how readily a business will be able to raise capital to meet future needs when deciding how to allocate capital. For example, with major financial institutions with tens of trillions of dollars in assets joining the Partnership for Carbon Accounting Financials, for example, that can be expected to “have profound effects on high-emitting companies’ access to capital.”

This principle applies, however, not just with regard to climate change, but also with regard to ESG issues more broadly. Issuers which perform well on ESG metrics now reportedly enjoy a substantial and growing competitive advantage in accessing capital when compared to issuers who do not perform well on ESG metrics. For example, a McKinsey survey of C-suite leaders found that leaders “would be willing to pay about a ten percent median premium to acquire a company with a positive record for ESG issues over one with a negative record.” Similarly, a study by MSCI found that the “market seemed to reward companies that took steps to improve ESG practices” by lowering their cost to access capital. Evidence that ESG-related information is already significantly affecting the costs issuers pay to access capital suggests that it is material under even the narrowest definition of financial materiality.

Moreover, even as flows to ESG strategies continue to grow, there is evidence that domestic sustainable finance markets may be experiencing significant capital outflow to foreign markets, particularly to the EU, that have more robust and transparent ESG disclosure.

---

128 One exception would be where companies are making public statements with regard to ESG issues – e.g., with regard to their commitment to a net zero economy or promoting racial diversity in their hiring – that would require additional disclosures to render those statements not misleading.

129 Virginia Harper Ho, Nonfinancial Risk Disclosure and the Costs of Private Ordering, 55 Am. Bus. L.J. 407, 430 (“The limited amount of material ESG information contained in most firms’ financial reports is due in part to the fact that federal securities law does not require issuers to disclose all material information within periodic reporting.”); Commissioner Peirce, Lucy’s Human. (“Most ESG reporting occurs outside of SEC filings, because companies are determining that the information is not material to an investment decision.”); Donald C. Langevoort & G. Mitu Gulati, The Muddled Duty to Disclose Under Rule 10b-5, 57 Vand. L. Rev. 1639, 1644 (2004) (“Materiality refers to the matter of whether a piece of information would likely be important to the reasonable investor. Duty, by contrast, refers to whether there is an obligation to disclose a certain category of information. As the courts state repeatedly, the former is usually a factual question and the latter a question of law. There are many facts … that can fall within the definition of materiality yet do not have to be disclosed.”).

130 Ross, The Role of Accounting and Auditing.


regulations and ESG investment product labeling restrictions. According to a recent Bloomberg article, for example, “European firms have built a seemingly unassailable lead in the booming $40 trillion sustainable finance industry.” Among other areas, “Europe dominates in the debt markets, where U.S. green bond sales fell 5% in a record year for global issuance,” according to the article, “and in sustainable funds, where inflows to European offerings were about five times larger this year than investments in the U.S.” Interestingly, this evidence directly contradicts the argument put forward by some that convergence to internationally recognized ESG metrics threatens to decrease the attractiveness of U.S. capital markets. On the contrary, the failure of U.S. regulators to keep up with demands for improved ESG disclosures appears to be hurting our competitiveness in global markets. As Ivan Frishberg, of Amalgamated Bank, told Bloomberg, “having a robust set of disclosures and requirements for the finance sector could put the U.S. in a position of leadership and partnership globally.”

In short, mandating ESG-related disclosure falls well within the Commission’s authority. Much of the information that comes under the ESG heading – whether related to climate change, racial diversity and inclusion, corporate governance practices, or working conditions – is clearly material to the decisions investors large and small make about how to allocate their capital, whether to buy, hold, or sell a particular stock, and how to vote their proxies. It also provides information that is used by other stakeholders, including financial institutions, credit rating agencies, and financial regulators, in ways that are critically important to the fair and orderly operation of our markets. And yet, as we discuss further below, this information is not currently being disclosed in a consistent, decision-useful form. This gap between investor needs and company practices is precisely the sort of market failure that demands SEC intervention.

II. Recommendations for Commission Action

The SEC’s disclosure requirements are intended to capture the total mix of information material to investor decision-making. Unfortunately, with respect to eliciting decision-useful ESG-related disclosures, the Commission’s current rules have fallen short of that standard. And while voluntary disclosures have helped to fill the gap in certain areas, they do not entirely meet the need for consistent, comparable, decision-useful information about climate and other ESG topics. To close this information gap, the SEC must amend the current disclosure requirements to capture necessary ESG information, including but not limited to climate-related information. As we discussed above, the Commission is not limited to requiring disclosures that are financially material, but we believe it is logical for the Commission to start with those issues that have been identified by investors as material to their investing and voting decisions and as priorities for updating. In deciding what information is material, however, the Commission should base its assessment on the views of investors and not adopt the narrow, issuer-driven definition of financial materiality some would seek to impose.

134 Id.
136 Marsh, Bloomberg Green, U.S. Falls Further Behind.
In addition, the Commission must remain sensitive to the fact that, just as investors’ views of what is material have changed markedly over the nearly 90 years since the securities laws were enacted, they are likely to continue to evolve in the future. This is perhaps particularly likely with regard to a number of the ESG-related issues discussed here, as our knowledge and society’s attitudes continue to change. Moreover, investors’ views of what issues fit within the ESG framework are also likely to evolve. The Commission will, therefore, need to continuously review and update its required disclosures in this area to ensure that they are meeting investors’ needs. Ultimately, however, what is important is not whether some issue carries the “ESG” label, but rather whether it is important to investor decision-making and the fair and orderly functioning of our markets. Viewed through this lens, the following are areas that we view as priorities for Commission attention in the near term.

A. Investors need better information with which to price climate-related risks and identify climate-related opportunities.

Climate change-related data, the financial risks associated with this data, and the methodologies and assumptions used to obtain and present this data are material to the decision-making processes of reasonable investors. The SEC should, therefore, undertake rulemaking to mandate the disclosure of this information and, as appropriate, issue guidance to clarify new and existing disclosures in this area. As discussed throughout this letter, climate change-related disclosure is not simply a means to make the world a more livable place (although that would certainly be a positive side-effect). Rather, it is increasingly a key element in investors’ decision-making and risk management strategies. As we discuss further above, and as Commissioner Lee recently pointed out, “[...] we are increasingly seeing all manner of market participants embrace ESG factors as significant drivers of decision-making, risk assessment, and capital allocation precisely because of their relationship to firm value.”

In order to facilitate the incorporation of climate-related risks and opportunities into investor decisions, the Commission asks how markets are currently pricing climate impacts and how registrants are analyzing these costs. These two questions get to the heart of the current demand for improved disclosures. Simply put, in the absence of complete and comparable information, investors do not appear to be adequately pricing climate risk into equities. As for how issuers are analyzing climate risk, for the most part we don’t know. Given the potential for climate change to disrupt the economy and the financial system, both acutely and in the long term, the failure to incorporate those impacts into the pricing of securities poses a substantial risk, not just to investors, but to the fair and orderly functioning of our markets.

---

137 We discuss below concerns that ESG labels may be used in ways that are confusing or misleading to investors. See p 65-68.
138 Commissioner Lee, Material World.
140 The Economist, Why Are Investors Not Pricing In Climate-change Risk? (June 2, 2020), https://www.economist.com/graphic-detail/2020/06/02/why-are-investors-not-pricing-in-climate-change-risk. (“More companies are disclosing their climate risks, but they are still in the minority. Without this information, it is hard for investors to gauge the threat that companies may face.”)
That said, we are not climate scientists, nor are we experts in the area of financial climate risk analysis. We have not, therefore, attempted to address every topic that might be relevant to a comprehensive climate disclosure regime. Instead, the following section addresses a few key areas where we believe enhanced disclosures are clearly needed.\textsuperscript{141}

1. Current climate change-related disclosures do not enable investors to properly price climate change-related risks.

As pointed out in a 2020 article, “New research suggests that the risk of climatic disasters such as floods, storms and wildfires are not reflected in the price of equities around the world.”\textsuperscript{142} As the basis for this research, the International Monetary Fund (IMF) examined roughly 350 large climatic disasters over the past 50 years and found that the average impact “has been modest: a drop of 2 percent for banking stocks and 1 percent for the whole market.”\textsuperscript{143} It cited as an example Hurricane Katrina, which “had the largest damage in absolute terms in our sample (1 percent of U.S. GDP),” and yet “had no discernible impact on the U.S. stock market index.” The IMF went on to explain that pricing this increase in climate-related physical risk is “a daunting challenge for equity investors, who need to estimate the likelihood of various climate scenarios and their implications for physical risk at the firm level based on climate science, and expected mitigation and adaptation actions.”\textsuperscript{144} Looking retrospectively to 2019 equity valuations across countries, they found that those valuations “did not reflect any of the commonly discussed global warming scenarios and associated projected changes in hazard occurrence or incidence of physical risk. This apparent lack of attention could be a significant source of market risk looking forward,” they warned.\textsuperscript{145}

\textbf{Calm before the storm}

\textit{Climatic disasters and share prices}

\begin{itemize}
\item \textbf{Climatic disasters* have a modest effect on share prices...}
\item \textbf{...and there is no relationship between climate risk and equity valuations}
\end{itemize}

\textsuperscript{141} You should, therefore, not view a failure on our part to mention a particular topic as evidence that we do not view it as important.

\textsuperscript{142} The Economist, \textit{Why Are Investors Not Pricing In Climate-change Risk?}.

\textsuperscript{143} IMF Blog.

\textsuperscript{144} Id.

\textsuperscript{145} Id.

\textsuperscript{146} Id.
If, as this analysis suggests, investors aren’t incorporating climate change risks into share pricing, the question arises as to why. For starters, and as discussed above, measuring these risks is challenging, and investors generally don’t have the actionable information necessary to do so. Without the tools necessary to build climate change-conscious portfolios, in the form of improved mandatory disclosures, investors are left to the devices of a market that ignores those risks. That includes not just physical risks, of the type explored in the IMF study, but also transitional risks (and opportunities) that may arise as we move toward a more sustainable economy. As explained in a 2020 BlackRock report, “The fundamental point often overlooked is the concept of a long transition between now and a future state, driven by investment flows, as sustainability effects become embedded in market pricing. Because these flows are in their early stages, we believe that the full consequences of a shift to sustainable investing are not yet in market prices.”

Though not yet a widespread reality, market pricing of climate change impacts is arguably a nascent trend that will continue to expand and increase in prevalence and intensity, if for no other reason than the significant reallocation of investor dollars toward ESG-linked investment funds.

Despite inadequate data and potential pricing gaps, investors are pouring money into ESG-related investment vehicles. Bloomberg Intelligence data estimates that “[g]lobal ESG assets are on track to exceed $53 trillion by 2025, representing more than a third of the $140.5 trillion in projected total assets under management.” It further reports that, “[w]hile Europe accounts for half of global ESG assets, the U.S. has the strongest expansion this year and may dominate the category starting in 2022.”

Bloomberg Intelligence data also highlight significant ESG-focused investment flows in the ESG-linked ETF and ESG-linked debt markets.

---

149 Id.
150 Id.
Taken in combination, the rising capital inflow toward ESG-focused investment vehicles, evidence that capital markets are failing to properly price climate change risks, and a common refrain among investors that “they cannot readily use companies’ sustainability disclosures to inform investment decisions and advice accurately,”\textsuperscript{153} should set off alarm bells for the Commission. Put simply, investors are seeking to either mitigate climate change-related risks or to realize the opportunities of ESG-focused investing, but unfortunately are met with inconsistent information and potentially flawed pricing. As a result, they may end up taking on unintentional and unaccounted for risks.

2. The Commission should require disclosure of decision-useful information reflecting climate change-related risks and issuers’ exposure to these risks.

Due to the current climate change-related risk environment, the overwhelming likelihood that these risks will continue to increase exponentially, the lack of reliable and comparable

\textsuperscript{151} Id.
\textsuperscript{152} Id.

29
information in the marketplace with which to price these risks, and the resounding investor demands for this information, the Commission is compelled to act. Toward that end, it should develop rules to close these financially perilous, climate-related information gaps. In considering what climate-related information companies should be required to provide, the Commission should seek to provide the information that would enable investors to accurately understand their exposure to climate change risks and to realize the opportunities arising from climate change-related risk avoidance and resiliency. The issue is too important to be left to the sole purview of third-party organizations and costly data researchers, sifting through inconsistent, voluntary sustainability reports to produce quasi-useful information about key climate change-related risks and opportunities.

The Financial Stability Board issued a report in late 2020 that identified various threats to our financial system posed by climate change.154 Although different sectors of the economy will be affected in different ways, this analysis may prove informative as the Commission determines what disclosure rules will best elicit risk-related information from issuers. As the report points out, “[r]isks to financial stability from climate change can be divided into physical and transition risks. The value of financial assets/liabilities could be affected either by the actual or expected economic effects of a continuation in climate change (physical risks), or by an adjustment towards a low-carbon economy (transition risks).”155

Physical risks include, but are not limited to, flooding, sea level rise, drought, wildfires, and extreme weather events. Notably, physical risk events are commonly experienced in conjunction with one another, rather than as acute events.156 Transition risks refer to changing policies and regulations, changing costs of doing business, changing access to resources, and new or rising costs associated with GHG emissions. Transition risks may also arise from the cost of moving toward lower emission technologies, costs of infrastructure improvements to build climate change resiliency (e.g., stormwater management, waste management, or environmental remediation), and other general costs of transitioning to a lower carbon economy.157 The TCFD explains that, “Transiting to a lower-carbon economy may entail extensive policy, legal, technology, and market changes to address mitigation and adaptation requirements related to climate change. Depending on the nature, speed, and focus of these changes, transition risks may pose varying levels of financial and reputational risk to organizations.”158

155 Id.
156 See e.g., Leslie Kaufman and Eugene Reznik, Bloomberg Green, California’s Epic Drought Is Parching Reservoirs and Worrying Farmers (June 3, 2021), https://www.bloomberg.com/news/features/2021-06-03/california-s-epic-drought-is-parching-reservoirs-and-worrying-farmers?in_source=postr_story_2. (The article illustrates the compounding nature of physical climate risks, where drought in California, which “could be entering an era of mega-drought, a period when extreme water scarcity lasts for decades rather than years,” will exacerbate water scarcity and increase wildfire risk, putting agricultural operations, business and homeowners at risk of catastrophic property and economic loss. Researchers “estimated that man-made changes to the climate were responsible for 47% of the drought’s severity.” Due to the drought, Governor Gavin Newsom recently extended an emergency declaration to encompass 41 of the state’s counties, home to roughly 30% of the state’s population.)
158 Id.
Exposure to these risks are not reflected in the periodic issuer filings currently required by the Commission.\textsuperscript{159} \textsuperscript{160} Nor are they adequately reflected by disclosures that only include an issuer’s GHG emissions.\textsuperscript{161} In addition, we need disclosures that explain how an issuer’s business may be exposed to climate change impacts, provided in a way that is distinct from, and in addition to, disclosures relating to an issuer’s emissions data. To achieve this goal, CFA supports the TCFD’s recommendation that issuers should “provide such disclosures in their mainstream (i.e., public) annual financial filings.”\textsuperscript{162} Disclosure areas should include, but should not necessarily be limited to, descriptions of:

- an issuer’s assessments of its material climate-related risks, including physical and transition risks, its plans for addressing those risks, and the projected cost of those plans.\textsuperscript{163}
- an issuer’s governance mechanisms, board oversight, and management structures as they relate to climate change risks and opportunities;
- the mechanisms, policies, and best practices for assuring the completeness and reliability of disclosures regarding climate change-related risks;
- the climate change scenarios and assumptions made in the determination of climate change-related risks; and
- the climate change-related performance metrics, benchmarks, and organizational objectives used.

CFA’s recommendations for Commission rulemaking on climate change-related risk disclosure are closely aligned with those of the TCFD. However, as the Commission develops rules around climate change-related risks, the agency should remain attuned to the complexities and nuances of this evolving topic, and CFA cautions against overreliance on the recommendations of the TCFD, or any individual third-party framework. As an April 2019 article points out, “[u]nderstanding physical climate risk can be a complex process, particularly as it’s an emerging topic and best practice analysis is still being established in the finance sector,” and further posits that the TCFD in particular is “failing to resolve the differences


\textsuperscript{160} See Madison Condon et al, \textit{Mandating Disclosure of Climate-related Financial Risk}, Institute for Policy Integrity and Environmental Defense Fund (Feb. 2021), at 21, https://policyintegrity.org/files/publications/Mandating_Climate_Risk_Financial_Disclosures.pdf. (“The SEC’s 2010 Guidance was a significant and important action: a U.S. federal agency recognized for the first time that climate change creates financial risks that should be disclosed by corporations. In practice, however, the SEC’s 2010 Guidance did not result in the disclosure many expected. In a report to Congress two years after its publication, the SEC concluded that it had not seen a noticeable change in disclosure from the year before the guidance came out to the year after” (citing Government Accountability Office, GAO-18-188, \textit{Climate Related Risks: SEC Has Taken Steps to Clarify Disclosure Requirements}, (Feb. 2018))

\textsuperscript{161} See pages 36-40.


\textsuperscript{163} We discuss this topic further in the next section.
between hazards, trends and risks.” In making this point, the article references a 2019 report by the BlackRock Investment Institute that focuses on the physical risks of climate change and, in part, highlights the variability of physical climate risks and the potentially disparate impacts between industry sectors. As the Commission develops new disclosure requirements related to climate, it will need to consider these additional perspectives and leverage the extensive research and analyses done by a diverse set of stakeholders.

3. Climate change disclosures should include explanations of risk management activities and scenario analyses.

Climate change-related impacts are frequently categorized by risk type, which can be physical, transitional, and/or reputational. Different issuers will be impacted differently by these risks, and certain industries are more exposed than others to the impacts of climate change. Therefore, to allow investors the opportunity to fully understand the climate change-related risks identified by issuers, the SEC should require additional disclosures relating to risk analyses, risk management strategies and methodologies, the costs to issuers represented by these risks, and the climate change-related assumptions and conclusions used by issuers in determining these risks and associated impacts. Where possible, these disclosures should include concrete metrics, such as a company’s liability reserves related to potential climate-related litigation. Requiring concrete data, where feasible, would reduce the risk of boilerplate disclosures about possible risks and give investors better information about how the company is valuing those risks for purposes of its own internal risk-management.

Disclosures should also include information explaining the climate change scenarios and modeling used in making risk determinations, as well as those used in calculating the costs of emissions and climate change-related financial risks. Descriptions of these individualized risk considerations and risk management structures would provide investors with the information needed to understand connections between climate change-related metrics, e.g., scope 1, 2, and 3 GHG emissions, and the climate change-related information required to be disclosed in an issuer’s financial statements. To the extent that these disclosures address management’s assessment of climate risks, and the basis for that assessment, they would appropriately be included in the MD&A section of an issuer’s annual report.

Similarly, disclosure of climate change scenarios and assumptions should undergird descriptions of emissions management, impact mitigation strategies, and descriptions of an organization’s governance mechanisms surrounding climate change risk management.

167 In order to promote consistency in disclosures across companies, the Commission should consider requiring all companies to incorporate certain commonly accepted scenarios, based on a certain projected rise in temperature, for example, while leaving them free to incorporate other scenarios, so long as they clearly explain the assumptions behind those scenarios.
Essentially, issuers should show their work when making climate change-related determinations. This information is critical to an investors’ ability to more objectively assess and understand climate change-related disclosures, to verify the underlying assumptions that an issuer used to make these determinations, assess the adequacy of management’s response, and to understand ongoing analyses of changing climate dynamics and outcomes.168

The importance of disclosing these underlying assumptions is driven home by a recent example from the world of oil extraction. In 2020, oil and gas company BP recognized a permanent impairment of $16.8 billion as a result of changing its long-term assumptions regarding the price of oil from $70 per barrel to $55 per barrel and its long-term assumptions about the price of gas from $4 per British thermal unit (BTU) to $2.90 per BTU.169 In making the change, it cited “the likelihood of greater efforts to ‘build back better’ towards a Paris-consistent world.”170 Similarly, Total S.A. cited policies aligned with the Paris Climate Agreement on its demand projections when it lowered its oil price assumptions from $80 per barrel to $70 per barrel in its 2019 Annual Report, triggering a permanent impairment charge to net income of $306 million. In 2020, it announced a further impairment, “explaining that, given its carbon-neutral strategy, some of its assets will be stranded.”171 Clearly, the assumptions Total and BP made about the future price of oil were material to their finances. Yet, as explained in a report from the Center for American Progress, “many companies, especially in the United States, have not disclosed the significant assumptions embedded in their financials.”

While the financial impact of assumptions about commodity prices may seem obvious, even something as esoteric as the statistical method used to estimate unknown data can also have a significant effect on ESG-related disclosures. A 2019 study demonstrated this principle by comparing the real 2017 employee turnover rate of Lufthansa, 12.9%, with estimates garnered from three different imputation methods, which ranged from 4% to 9%.172 Given how sensitive climate scenarios can be to underlying assumptions, this effect is likely to be particularly significant in that context.173

168 See e.g., Elizabeth Kolbert, Three Scenarios for the Future of Climate Change, The New Yorker (Oct. 5, 2020), https://www.newyorker.com/news/annals-of-a-warming-planet/three-scenarios-for-the-future-of-climate-change. (This article broadly articulates three potential climate change scenarios, each influenced by various responses to climate change and each having different outcomes for developed and developing nations.)


170 Id.


These examples make it clear that the assumptions and methods companies are using to calculate their ESG disclosures matter, and they should be available for investors to scrutinize. Only then will investors and other users of SEC-mandated climate disclosures be able to assess for themselves whether the assumptions appear valid. Because different investors can be expected to view the issues differently, one investor may view as overly optimistic an assumption that another investor views as overly pessimistic. Accordingly, they are likely to make different investment decisions. It is only by seeing the assumptions, however, that they are able to make an informed decision.

4. The SEC should look to existing data frameworks when determining the relevant, quantifiable climate change-related information to be disclosed.

As policymakers in the United States and around the globe look to reduce greenhouse gas (GHG) emissions, these demands could have a significant financial impact on companies as they plan to meet these new policy demands. As a result, information about GHG emissions, and plans to reduce those emissions, is a key area of interest to many investors. Legislation has been introduced in Congress that would require such disclosures.\textsuperscript{174} But the Commission does not require a new grant of authority to act, and we recommend that it do so without delay.

As it considers how to move forward, the Commission can and should make use of the various resources that exist in the public and private sectors to assist businesses, both large\textsuperscript{175} and small,\textsuperscript{176} in calculating their GHG emissions. For example, the Greenhouse Gas Protocol launched in 1998 specifically to develop broadly applicable and internationally accepted GHG accounting and reporting standards.\textsuperscript{177} Similarly, the Task Force on Climate-related Financial Disclosures (TCFD) has published recommendations and implementation guidance that may provide a workable baseline disclosure framework to help regulated issuers identify climate change-related metrics and risk information. If and when the SEC develops industry- and sector-specific rules and guidance, the SASB has developed standards and materiality assessment guidance for companies in 77 different industries.\textsuperscript{178} The SEC can implement and build upon these and other frameworks to elicit decision-useful climate information from issuers.\textsuperscript{179} We defer to the expertise of investors with more experience using these disclosures regarding which approach provides the necessary information is the most decision-useful form and to what extent these existing frameworks may need to be augmented.

\textsuperscript{174} Climate Risk Disclosure Act of 2021, H.R. 2570, 117th Cong. (2021), \url{https://www.congress.gov/bill/117th-congress/house-bill/2570/text}. The bill defines greenhouse gases to include carbon dioxide, hydrofluorocarbons, methane, nitrous oxide, perfluorocarbons, sulfur hexafluoride, nitrogen trifluoride and chlorofluorocarbons; and may include any other anthropogenically-emitted gas that the Administrator of the Environmental Protection Agency or the Intergovernmental Panel on Climate Change determines may contribute to climate change.


\textsuperscript{179} Task Force on Climate-related Financial Disclosures, \textit{Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures} (June 2017), \url{https://assets.bbhub.io/company/sites/60/2020/10/FINAL-TCFD-Annex-Amended-121517.pdf}. 34
Commonly, GHG emissions are categorized as scope 1, 2, or 3 emissions. Emission scopes refer to the level of control an organization has over the source of the emissions, with scope 1 being direct control and scope 3 being limited or no control over the source of emissions. The TCFD recommends that organizations “provide their Scope 1 and Scope 2 GHG emissions and, if appropriate, Scope 3 GHG emissions and the related risks.” TCFD goes on to recommend that GHG emissions should “be calculated in line with the GHG Protocol methodology to allow for aggregation and comparability across organizations and jurisdictions. As appropriate, organizations should consider providing related, generally accepted industry-specific GHG efficiency ratios.” While recognizing the challenges, we believe the Commission should consider requiring, and not just encouraging, disclosure of scope 3 emissions.

The more control a company has over its emissions, the easier it will be to measure and report those emissions. Reporting scope 3 emissions is therefore likely to be more challenging for issuers than reporting scope 1 emissions, and these challenges will assuredly vary between different sectors and industries. But capturing scope 3 data will be critical to presenting a clear picture of this important topic. The simple fact is that a majority of many issuers’ GHG emissions are reflected in its scope 3 emissions. The CDP estimates, for example, that a company’s indirect emissions are 5.5 times greater than direct, operational emissions. That makes them squarely relevant to investors’ ability to analyze their impacts and associated financial risks, particularly transition risks.

Transition risks are uniquely magnified by the Biden Administration’s promise of a government-wide transition to a net-zero economy, and management of scope 3 emissions will presumably be a key element to meeting net-zero goals. In the same vein, the SEC may also view the policy landscape surrounding the Paris Climate Agreement as one that necessarily includes the full value chain of registrants’ GHG emissions. Because scope 3 emissions represent such a significant portion of the GHG emissions produced by our economy, the management and mitigation of them will be critical in meeting the nationally determined contribution (NDC) that the U.S. has submitted to the UNFCCC Secretariat under the Paris Agreement. While the NDC does not specifically identify scope 3 emissions, the realities of a “50-52 percent reduction below 2005 net emissions levels” by the year 2030 are likely to include them.

---

180 Id. at 20.
181 Id. at 20.
184 The United States of America Nationally Determined Contribution (April 2021), https://www4.unfccc.int/sites/ndcstaging/PublishedDocuments/United%20States%20of%20America%20First/United%20States%20NDC%20April%2021%202021%20Final.pdf.
Moreover, research has shown that, when emitters are subject to tighter emissions regulation, they respond by outsourcing their emissions into their supply chain. Absent a requirement for disclosure of scope 3 emissions, we are all too likely to see similar results, with companies touting the extent to which they have reduced their GHG emissions when in reality they have simply relocated those emissions to a different link in the supply chain. That would deprive investors of information needed to assess climate risks, and it would deprive policymakers of important information about the steps needed to reach their policy goals. To the extent that incomplete disclosures lead to an inadequate response, that increases the risk of more draconian policy changes in the future, with a commensurate increase in transition risks for issuers.

While the Commission will doubtless encounter resistance to any such requirement to require disclosure of scope 3 GHG emissions, the information is clearly material and should be reported if feasible. And while scope 3 data for GHG emissions may pose certain challenges for registrants to measure and report, there are several organizations, including the Science Based Targets Initiative, CDP, and The Climate Registry, that have published extensive guidance to help companies do so. These resources should prove especially beneficial as the Commission adopts its own disclosure requirements around decision-useful emissions data and assesses the feasibility of requiring scope 3 disclosures.

B. Material ESG disclosures should extend beyond climate change-related information.

While climate change has dominated the ESG disclosure conversation, material ESG-related topics are not limited to greenhouse gas emissions and climate change-related risks. Shareholder proposals, existing ESG frameworks, and corporate ESG reports all clearly demonstrate that the boundaries of material ESG information extend well into other areas of issuers’ operations.

---


\[^{186}\] Nicole Labutong and Vincent Hoen, *How can companies address their scope 3 greenhouse gas emissions?*, Science Based Targets (May 2018), https://sciencebasedtargets.org/blog/how-can-companies-address-their-scope-3-greenhouse-gas-emissions.


1. The scope of material ESG information includes non-climate-related environmental practices and associated risks.

Measured against the actual breadth of the ESG issue sphere as it is applied in the context of voluntary corporate sustainability reporting, it’s clear that the current scope of enumerated environmental disclosures required by the SEC is inadequate. Such environmental disclosures are currently limited to the information provided in Regulation S-K filings, primarily in items 101 and 103, where registrants offer disclosures relating to “description of business” and “legal proceedings,” respectively. Environmental issues may also be covered tangentially in the risk factors and MD&A sections. In the absence of a Commission mandate to discuss the broad range of environmental risks, however, that discussion may be limited to discussion of climate change-related risks and impacts. As Commissioner Lee noted in her statement on the Commission’s 2020 proposal to “modernize” Regulation S-K, current requirements have not produced “sufficient disclosure to ensure that investors are getting the information they need – that is, disclosures that are consistent, reliable, and comparable.” That’s true with regard to climate-related risks, and even more of a problem for the broader range of environmental issues.

Additionally, recent changes to Regulation S-K have further expanded the gap between the environmental disclosures that reasonable investors need and the limited information provided by required disclosures. Much of the attention at the time these rules were adopted was focused on the Commission’s failure to mention climate or related risks, the “elephant in the room,” as Commissioner Lee described it. However, the Commission also increased the monetary threshold for disclosing environmental litigation, which reduced the amount of information that needs to be disclosed, and consolidated disclosures of capital expenditures for regulatory compliance under environmental laws and capital expenditures for compliance with all other material government regulations, making it more difficult to identify or isolate environmental compliance costs. It took these steps in direct opposition to investors’ expressed preference to invest in companies with sound environmental practices, as discussed above.

Information that accurately reflects a registrant’s past, current, and future environmental impacts (e.g., pollution and waste emissions, resource consumption, land use, and impacts on wildlife and ecosystems) is key to investors’ ability to analyze and manage risk. This data informs considerations of operational risks, reputational risks, compliance and enforcement risks, transition risks, damages liability risks, and financial risks (e.g., stranded industrial assets due to climate change are potentially an enormous liability for many companies). It is worth noting,
for example, that although the EPA has promulgated certain, limited regulations relating to GHG emissions, the bulk of the agency’s statutory remit and related rules regulate pollutants and toxic chemicals that are not designated as GHGs. Thus, understanding a company’s environmental risks and opportunities requires a focus on far more than climate-related risks.

In reality, investors hoping to obtain material environmental performance information about a regulated issuer are likely limited to reviewing voluntary ESG reports made by the company itself (the veracity and completeness of which are often questionable) or reviewing data compiled by a third party. Neither source is sufficiently accessible, verifiable, or easily comparable to meet investors’ needs for decision-useful information. Exacerbating the problem, the information remains largely disconnected from the associated financial risks. Information gaps of this nature manifest the double negative of simultaneously limiting market participants’ ability to make informed investment decisions and limiting issuers’ ability to realize nascent market opportunities and exploit competitive advantages.

Consider the recent, expanded focus on environmental justice by the Biden Administration and by state and local governments. According to EPA’s definition, environmental justice is the fair treatment and meaningful involvement of all people regardless of race, color, national origin, or income, with respect to the development, implementation, and enforcement of environmental laws, regulations, and policies. The White House has set out an ambitious policy agenda relating to the incorporation of environmental justice considerations into federal infrastructure investments (including but not limited to climate change adaptation and a net zero economic transition), federal policy agendas, and regulatory enforcement. In announcing this initiative, it stated that it is the policy of the administration “to secure environmental justice and spur economic opportunity for disadvantaged communities that have been historically marginalized and overburdened by pollution and underinvestment in housing, transportation, water and wastewater infrastructure, and health care.” Additionally, state-level

199 Press Release, Third TCFD Status Report Shows Progress & Highlights Need for Greater Climate-Related Disclosures and Transparency, TCFD, (Oct. 29, 2020), https://assets.bbhub.io/company/sites/60/2020/10/TCFD-2020-Status-Report-Press-Release_FINAL.pdf. (“However, despite the significant momentum, the 2020 Status Report highlights the continuing need for progress in improving levels of TCFD-aligned disclosures given the urgent demand for consistency and comparability in reporting. In particular, disclosure of the potential financial impact of climate change on companies’ businesses and strategies remains low.”)
200 See World Economic Forum, Embracing the New Age of Materiality: Harnessing the Pace of Change in ESG, (March 2020), http://www3.weforum.org/docs/WEF_Embacing_the_New_Age_of_Materiality_2020.pdf. (“To win in the coming decade, investors and companies must equip themselves with forward-looking and proactive approaches to materiality. This paper offers a framework that provides investors with guidance on the signals to look for to better identify dynamic ESG issues and to incorporate them into the process of portfolio construction, security selection and stewardship.”)
regulators and states’ departments of justice are increasing pressure related to these complex issues, both through legislation and enforcement.203

A government- and economy-wide shift to incorporate environmental justice considerations certainly creates new risk areas, but for those registrants that properly manage these risks, it also presents significant opportunities. Among them are access to the many “reasonable investors” that incorporate environmental justice considerations into their own investment strategies. With the realistic prospect of significant changes to policy-making, permitting, enforcement, and infrastructure investment, the issuer and investor communities may reasonably deduce that information relating to the environmental justice impacts of reporting companies is material, or at least potentially material, regardless of their personal beliefs about climate change, climate change risks, or environmental justice itself. The scope of this measurable and reportable information includes, but is not limited to, GHG emissions, waste and pollution emissions, environmental burdens imposed on minority and low income communities, and community engagement.204 Under the SEC’s current disclosure regime, investors do not have ready access to the information underlying these impacts in a meaningful way, and the private sector generally does not disclose this data on a voluntary basis.

Simultaneously, investors are seeing ubiquitous pledges by the private sector in support and furtherance of the ongoing racial justice movement, one that experienced a meteoric rise to national attention following the murder of George Floyd on May 25, 2020.205 206 Significant attention is also being paid to the nexus between climate change impacts on the most vulnerable populations, primarily the same minority and low income communities that have long borne a disproportionate burden of environmental contamination.207 As discussed above, the SEC and courts have long recognized information that is needed to render other statements not misleading as material. Without access to the data that underpins the activities and public statements of registrants relating to these issues, how can anyone properly assess their risks, impacts, or the veracity of their statements made about them? How can investors know if pledges in support of racial and environmental justice are not actually material misstatements that hide the true position and practices of the issuers making the pledges?

206 As You Sow, Racial Justice Scorecard (March 4, 2021), https://www.asyousow.org/our-work/social-justice/racial-justice. (“Of the S&P500 companies, 66% made statements after the George Floyd’s murder. Of these 50% were posted on their websites; 16% on social media and 34% were silent”).
Environmental justice considerations are inextricable from the current racial justice movement, the long arc of the civil rights movement, and the ongoing climate crisis.\textsuperscript{208} \textsuperscript{209} Investors, conscious of potentially seismic financial risks to their investments posed by intersectional issues like the impacts of environmental justice, should be made aware through regulated disclosure of their own exposure to these risks. Larry Fink, CEO of BlackRock, similarly urged this intersectional view when he wrote in his annual letter to CEOs:

> Questions of racial justice, economic inequality, or community engagement are often classed as an “S” issue in ESG conversations. But it is misguided to draw such stark lines between these categories. For example, climate change is already having a disproportionate impact on low-income communities around the world – is that an E or an S issue? What matters is less the category we place these questions in, but the information we have to understand them and how they interact with each other. Improved data and disclosures will help us better understand the deep interdependence between environmental and social issues.\textsuperscript{210}

The Commission should keep this principle in mind as it considers what disclosures are needed related to environmental issues and how they relate to racial justice issues. To the degree that a company’s environmental practices also expose its workers to health and safety risks, there would be a similar intersection between environmental disclosures and human capital management disclosures.

In short, in undertaking new ESG-related rulemaking, the Commission should mandate disclosures that will enable investors to determine the wide range of material environmental risks (and opportunities) a company may face, its plans to address those risks (or seize those opportunities), and the potential costs of any such strategy. This should include unwinding the changes adopted in the recent revision to Regulation S-K, which actually decreased the information available to investors on this important topic. The Commission should seek to ensure that the information that is required to be provided is sufficiently detailed to enable investors to objectively assess the environmental performance of issuers and to assess the veracity of public statements that companies make about their environmental practices and commitments. Finally, in undertaking this rulemaking, the Commission should seek to ensure that investors are able to obtain information regarding the environmental justice and worker impacts of the company’s practices.

2. The SEC may look to existing voluntary disclosure frameworks when identifying relevant environmental performance areas, but should not be constrained by them.

For the SEC to appropriately elicit relevant environmental performance disclosures from registrants, the agency may look to the current scope of voluntary ESG disclosures elicited by existing voluntary ESG frameworks. For example, the Global Reporting Initiative encourages

\textsuperscript{208} Environmental Protection Agency, *Environmental Justice Timeline* (last updated June 2, 2017),\textsuperscript{208} \textsuperscript{209} https://www.epa.gov/environmentaljustice/environmental-justice-timeline.\textsuperscript{208} \textsuperscript{209} David Lammy and Manish Bapna, *There is No Climate Justice Without Racial Justice*, Time Magazine (May 3, 2021),\textsuperscript{208} \textsuperscript{209} https://time.com/6017907/climate-emergency-racial-justice/.\textsuperscript{208} \textsuperscript{209} Larry Fink, 2021 letter to CEOs, BlackRock, Inc. (2021),\textsuperscript{208} \textsuperscript{209} https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.
disclosure of the following environmental categories: Energy; Water and Effluents; Biodiversity; Emissions; Waste; Environmental Compliance; and Supplier Environmental Assessment. The SASB’s framework similarly identifies financially material environmental topics that include: GHG Emissions; Air Quality; Energy Management; Water & Wastewater Management; Waste & Hazardous Materials Management; and Ecological Impacts. These identified issue areas directly reflect the primary environmental compliance risks that stem from our state and federal environmental protection laws.

In addition, the SEC may look to the disclosure framework recently published by the World Economic Forum’s International Business Council (produced in consultation with the Big Four accounting firms), which lays out a globally-applicable set of performance areas for the purpose of integrating ESG information into mainstream regulatory filings. Environmental disclosure areas identified by this framework include land use and nature loss, freshwater availability, air pollution (this topic is separate and in addition to the topic of climate change), water pollution, solid waste, and resource availability. The relevant environmental performance areas of WEF’s IBC framework largely parallel those of GRI and SASB. In light of the IBC’s membership and its cooperation with the Big Four in its development, this framework also provides evidence that embrace of expanded ESG-related environmental disclosures, including those that go beyond climate change-related metrics alone, is not limited to the “woke left,” as some have suggested.

As the SEC moves toward adopting rules that will compel decision-useful environmental performance information from registrants, the scope and structure of the environmental information and related metrics currently captured by existing voluntary ESG frameworks may provide a workable baseline for the Commission to use in determining the appropriate scope of its own requirements. However, the agency should not unnecessarily tie its rules to the current boundaries of one framework or another. Rather, it should take a measured assessment of existing resources to identify those approaches that it, and investors, believe are most effective in presenting the necessary information. It should then adopt a regulatory approach to reviewing and updating the disclosures that is capable both of eliciting reliable and comparable performance information and of adapting to evolving priorities of investors.

The emergent environmental justice movement offers a timely example of where this approach will likely prove necessary. As discussed above, environmental justice is set to be a

---

211 Global Reporting Initiative, *ESG Standards Glossary* (2020),


http://www3.weforum.org/docs/WEF_IBC_Measuring_Stakeholder_Capitalism_Report_2020.pdf. (“This work defines a core set of “Stakeholder Capitalism Metrics” (SCM) and disclosures that can be used by IBC members to align their mainstream reporting on performance against environmental, social and governance (ESG) indicators and track their contributions towards the SDGs on a consistent basis.”)


215 See discussion below regarding updating of ESG disclosure requirements, pages 52-60.
regulatory and sociopolitical focal point across our government, but analysis of environmental justice impacts have largely remained separate from existing ESG considerations, and are not captured by the current mandatory disclosure regime. Other, thorny environmental issues will continue to arise as well – for example, the growing risks associated with PFAS chemicals. Contamination from PFAS, a class of toxic, ubiquitous substances that has received increasingly urgent regulatory attention at all levels of government, has an asbestos-like potential to disrupt industries and to alter corporate risk analysis for years to come. The Commission should provide disclosure pathways and require the granular information that will allow investors to receive decision-useful information on emergent environmental risk areas such as these. Requiring granular environmental performance metrics and robust environmental risk analysis in mainstream regulatory filings is the best way to accomplish this.

Concurrently, the Commission may determine that some of the information solicited by existing voluntary ESG frameworks, while relevant and in-scope for sustainability reporting purposes, may remain beyond the scope of materiality as it is defined in the SEC’s investor-focused context. While the Commission’s disclosure authority is not limited by materiality, its initial agenda should focus on those issues that investors have already identified as material. There are obvious reasons for the Commission to start with the areas of highest investor demand, but we believe there are good strategic reasons to start there as well. ESG opponents have already made clear their intention to challenge any such rules in court. Faced with that prospect, the Commission can reduce its litigation risks if it focuses on areas that are clearly material under a “reasonable investor” standard. While we believe enhanced environmental disclosures fit well within this framework, it will be important for the Commission to remain cognizant of these influences and externalities, both positive and negative, when considering how best to structure its ESG-related environmental disclosure rules.

C. Required disclosures should include relevant social and governance performance information.

ESG data that may fall into the “S” and “G” categories can and should be analyzed through the same lens with which we view environmental disclosures - i.e., investors should have reliable and comparable information about relevant, disclosable social and governance metrics when analyzing risks and opportunities relating to an issuer. Principal issue areas that have received elevated attention in this sphere include, but are not limited to: human capital management; labor practices and workplace safety; employee relations; diversity, equity, and inclusion; racial justice; executive compensation; anti-corruption and mitigation of conflicts of

---

219 Our separation and use of “E,” “S,” and “G” as performance categories, as highlighted elsewhere in this letter, should not be understood to imply they are separate and discrete issue areas. Rather, there is significant overlap and intersection between these categories, however, the categories provide a useful organizational tool for discussing these various, interrelated issues.
interest; human rights; and board oversight. Issuers should provide the investing public with transparent and comparable information about these topics. This letter focuses specifically on human capital management and diversity, equity, and inclusion, but the Commission’s forthcoming rulemaking should capture a wider set of ESG-related issues than just these.

S&P Global defines the “G” in ESG as, “[...] the governance factors of decision-making, from sovereigns’ policymaking to the distribution of rights and responsibilities among different participants in corporations, including the board of directors, managers, shareholders and stakeholders. Governance factors indicate the rules and procedures for countries and corporations, and allow investors to screen for appropriate governance practices as they would for environmental and social factors. A corporation’s purpose, the role and makeup of boards of directors, shareholder rights and how corporate performance is measured are core elements of corporate governance structures.”

In short, corporate governance provides the infrastructure and connective tissue through which all other ESG-related performance and disclosure must necessarily flow. To be comprehensive, an ESG disclosure framework must therefore include governance-specific disclosures.

The following graphic illustrates commonly considered governance-related performance areas:

<table>
<thead>
<tr>
<th>Exhibit 1: The Eight Criteria for Economic Dimension Scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Corporate Governance</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>2. Codes of Business Conduct</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>3. Risk and Crisis Management</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>4. Supply Chain Management</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>5. Tax Strategy</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

Source: RobecoSAM. Chart is provided for illustrative purposes.

Information about a company’s governance practices related to ESG should be communicated to investors through mainstream regulatory filings. Robert Eccles, in his article “The Investor Revolution,” points to rising pressure, primarily through shareholder activism, on

---


corporate managers and directors to embrace and employ ESG-centric strategies in their operations. He states, “Shareholder activism is on the rise in financial markets—and ESG is increasingly becoming a focus of these interventions.”

“To respond to this shift in focus,” he urges companies to “publish a statement of purpose, provide investors with integrated financial and ESG reports, increase the involvement of middle managers in ESG issues, invest in robust IT systems, and improve internal systems for measuring and reporting ESG and impact performance information.”

Improved governance-related disclosures, including information on the structures and practices companies have in place to manage their ESG-related risks, are needed to support these efforts.

Additionally, there is the potentially nascent practice of companies tying executive pay to ESG performance. As PwC stated in a recent report, “Environmental, Social and Governance (ESG) issues now sit at the heart of good business practice, and for some companies have become a central strategic pillar. As a result, many companies around the world are linking executive pay to ESG goals – whether reducing emissions, customer welfare or workforce diversity.”

As PwC notes, however, ESG measures can be “hard to calibrate.” Without improved ESG disclosures, boards won’t have the reliable, comparable information they need to make those performance assessments, executives won’t know how their performance is likely to be assessed, and investors won’t have the information they need to hold corporations accountable for how they make those compensation decisions. Standardized and transparent disclosures around ESG issues generally, and governance practices specifically, would help to alleviate some of these risks.

D. Issuers should disclose quantitative and qualitative human capital management information because it is relevant and material to investors.

Human capital management (HCM) can be defined as the strategic approach taken, organizational structure around, management of, and performance indicators employed by companies in order to support, benefit, and harness the knowledge, skills, diversity, and health of their workforce. Prior to 2020, there were widespread calls for enhanced human capital disclosure requirements, and the need for better disclosures in this area has only increased since then. The pandemic and resulting economic downturn, in particular, have spotlighted the importance of company interactions with their employees, supply chains, and the public at large.

223 Id.
224 See Janice Koors, *Executive Compensation and ESG*, Harvard Law School Forum on Corporate Governance, (Sept. 10, 2019), https://corpgov.law.harvard.edu/2019/09/10/executive-compensation-and-esg/ (“these types of identified [ESG-related] actions may also be represented as a component of some executives’ performance-based compensation (particularly health and safety [...] ), but it is unlikely these factors are explicitly stated as ESG performance metrics.”)
In 2017, the Human Capital Management Coalition submitted a detailed and persuasive request for Commission rulemaking to begin closing the information gap that exists between what issuers are required to disclose and the information that investors need for fully-informed, risk-aware decision-making. The letter effectively describes the materiality of human capital-related information, arguing, “The importance of human capital is supported by decades of research. A large body of empirical work has shown that thoughtful management of human capital is associated with better corporate performance, including risk mitigation.”227 As a 2019 article in the Harvard Law School Forum on Corporate Governance stated, “In today’s business environment, integrating information around long-term value drivers like human capital and culture across company communications is increasingly important. A diverse and growing group of market participants view responsible corporate citizenship and increased attention to stakeholder interests—especially employees—as consistent with, and perhaps even critical to, creating long-term shareholder value.”228

Statements and actions from BlackRock add significant influence and investment dollars to these growing demands. Specifically, BlackRock asks “that companies demonstrate a robust approach to HCM and provide shareholders with the necessary information to understand how it aligns with the company’s stated strategy and business model. These disclosures may address how a company identifies its key human capital priorities, the policies in place to address these priorities, and how the board oversees management to ensure accountability.”229 In explaining its focus on these issues, BlackRock points to two key studies on the material value of high quality human capital management, stating that: “Research has consistently shown the importance of human capital to company performance. Companies included in Fortune Magazine’s ‘100 Best Companies to Work For’ list earned, over the long-term, excess risk-adjusted returns of 3.5%. Another report surveyed a multitude of studies on human capital and found that there is a positive correlation between human resource initiatives and investment outcomes such as total shareholder return, return on assets, return on earnings, return on investment, and return on capital employed.”230

Recently, Cyrus Taraporevala, President and CEO of State Street Global Advisors, sounded a similar note. He stated in his annual letter to CEOs: “[...] 2020 was no ordinary year. From a global health crisis that has taken the lives of nearly 2 million people, to a global conversation about racial justice, to continued long-term risks around the threat of climate change, the past year has cast a stark light on systemic vulnerabilities and reinforced the connections we see across sustainability, inclusion, and corporate resiliency. As such, our main stewardship priorities for 2021 will be the systemic risks associated with climate change and a

lack of racial and ethnic diversity. In particular, I want to explain how we intend to use our voice — and our vote — to hold boards and management accountable for progress on providing enhanced transparency and reporting on these two critical topics.”

231 These investor demands for more, better human capital-related disclosures are growing because, more and more, intangible assets like human capital are being understood to comprise a significant proportion of a company’s total market value.

CFA recognizes that the Commission recently adopted a principles-based approach to enhanced human capital management reporting requirements, as discussed further below. However, we believe additional rulemaking is needed to achieve the goals contained in the 2017 Human Capital Coalition letter, which we support. That letter identifies the following principal areas for improved disclosure:

- information that equips investors to “adequately assess a company’s business, risks and prospects, for investment, engagement or voting purposes”;
- Information that would “allow investors to more efficiently direct capital to its highest value use, thus lowering the cost of capital for well managed companies”; and
- the adoption of consistent, mandatory disclosure standards that would streamline the disclosure burden on issuers, create consistency for investors, and democratize access to the disclosure information.

233 We are convinced these improvements will only be achieved by requiring metrics-based disclosures, coupled with detailed descriptions of risk assessment and management strategies, key performance indicators and benchmarking practices, and the policies enacted to implement these strategies. Where appropriate, these disclosures should be reflected in the financial statements of issuers, and investors should be provided with the information necessary to understand how connections to financial statements were made. If adopted, these more detailed and concrete disclosures will serve to improve and support the principles-based disclosures already required in Regulation S-K.

1. Recent efforts to elicit human capital management disclosures in Regulation S-K fall short of the needs and demands of investors.

As referenced above, recent changes were made to “modernize” disclosure under Regulation S-K, and among them were efforts to enhance disclosure of certain information relating to human capital management. 234 Issuers must now include a “description of the registrant’s human capital resources, including in such description any human capital measures or objectives that management focuses on in managing the business, to the extent such disclosures would be material to an understanding of the registrant’s business taken as a

232 See Steve Klemash et al., How and Why Human Capital Disclosures are Evolving. (“A company’s intangible assets, which include human capital and culture, are now estimated to comprise on average 52% of a company’s market value.” [citing the Global Intangible Finance Tracker (GIFT)])
whole.” This expanded, principles-based approach to human capital disclosures is a step in the right direction, but remains inadequate for the purposes of investor decision-making and risk management, and should be revisited and enhanced as part of the Commission’s efforts to elicit decision-useful ESG-related information.

As Commissioners Robert J. Jackson, Jr. and Allison Herren Lee predicted in their joint statement when the rules were proposed, the principles-based approach adopted by the Commission has produced “inconsistent information that investors cannot easily compare.” That concern was verified by the findings of a new report from Neri Bukspan and Marc Siegel of Ernst and Young, which analyzed a set of disclosures made by 143 S&P 500 companies following the implementation of the Commission’s amended Regulation S-K disclosure requirements around human capital. The analysis identified significant disparities in the resulting disclosures, just as Commissioners Jackson and Lee had predicted. “Our analysis shows a wide disparity in the extent and areas discussed, as well as depth and approach that companies used to craft their disclosures, including in their use of measures, quantitative goals and targets, as well as key human capital-related performance indicators,” the report states. One way in which these disparities manifested themselves was in the wide range in the length of the disclosures. Among the 10-Ks analyzed, the report stated that, “we observed a wide range of pages of human capital disclosures, from a single paragraph/quarter of a page to three pages.”

Division of Corporation Finance Director John Coates voiced views in recent comments at a recent virtual NYU Roundtable, stating that disclosures that the Commission has received to date “displayed quite a range of variation,” including some that provided little if any information on the topic and others that laid out “a full range of qualitative and quantitative information.”

Disclosure disparities create or exacerbate information gaps, either from lack of robust disclosure or non-comparability between disclosures made. Information gaps create inefficiencies and costs for investors by limiting their ability to accurately assess risk exposure and limit their abilities to properly allocate capital. Some of these disparities may be the inevitable result of underlying differences among companies. As Former SEC Chair Jay Clayton stated at the time the rules were proposed, “I would expect that the material human capital information for a manufacturing company will be vastly different from that of a biotech startup, and again vastly different from that of a large healthcare provider.” Chair Clayton viewed those inherent differences as reason not to “prescribe specific, rigid metrics” that he argued “would not capture or effectively communicate these substantial differences.” Instead he argued that

---


237 Id.

238 NYU Law, Institute for Corporate Governance & Finance and NYU Stern Vincent C. Ross Institute of Accounting Research, Roundtable (April 30, 2021), Session 1. Recording available here: https://www.law.nyu.edu/centers/icgf/events.

disclosures should be focused exclusively on the efforts of companies related to “attracting, developing and enhancing its people” that “have a material impact on their performance.”

Subsequent experience has shown, however, that this approach, in which corporate managers are the sole arbiters of what information gets disclosed, doesn’t result in the consistent and comparable disclosures of the information that investors view as material. Specifically, what advocates of an exclusively principles-based approach apparently fail to recognize is that investors want and need specific information about the underlying drivers of high quality human capital performance (e.g., specific metrics and consistent information). If we are to succeed in providing them with the information they view as material, then the SEC’s disclosure requirements can’t be limited to only requiring the kind of widely variable, untethered assessments of human capital management that a principles-based rule too often elicits, especially when it’s rooted in an extremely narrow, management-driven view of materiality (i.e., only required if material to the business as a whole).

2. Existing voluntary ESG frameworks may help guide the Commission’s efforts to enhance human capital management disclosure rules.

As with other ESG-related topics discussed in this letter, existing ESG frameworks that capture human capital disclosures can serve as valuable resources and models for the Commission as it sets out to update its rules to make them more concrete and comparable. A 2019 article from the EY Center for Board Matters outlined the landscape of voluntary disclosure frameworks and the associated performance indicators used by each of these frameworks. These include standards on topics related to human capital from SASB, the Embankment Project for Inclusive Capital (EPIC), the Global Reporting Initiative, and the International Standards Organization. According to the article, each of these standards suggest key performance indicators (KPIs) that “companies may use to better communicate human capital value,” and these KPIs “generally correspond to those articulated by commenters on the SEC’s concept release and the Human Capital Management Coalition 2017 rulemaking petition to the SEC.” (See chart next page)

This suggests that there is broad agreement on areas where the Commission could, and should, improve its existing disclosure requirements by adding more concrete and specific requirements reflected in disclosure frameworks such as these. That, along with the Commission’s own review of high-quality disclosures provided under the existing rules, should drive the decisions the Commission makes with regard to the specific requirements of new mandatory disclosures.

---

240 Id.
241 Id.
242 Id.
3. Diversity, equity, and inclusion information is particularly relevant and material to investors.

“Diverse and inclusive cultures are providing companies with a competitive edge over their peers.”\textsuperscript{243} Taken from a 2019 Wall Street Journal study, this introductory line aptly encapsulates the notion that organizational performance on diversity, equity and inclusion has become squarely material to investor decision-making.\textsuperscript{244} According to the study, which analyzed S&P 500 companies, “the 20 most diverse companies in the research not only have better operating results on average than the lowest-scoring firms, but their shares generally outperform those of the least-diverse firms.”\textsuperscript{245} But it’s not just about share price performance;

\textsuperscript{245} \textit{Id.}
the study also points to business resiliency and long-term profitability as an outcome of diversity. “Analysts agree that diversity can help fuel innovation, which is critical to success in a fast-changing world where technological disruption has become the norm,” it states. And it provides several examples of industries and companies in which long-term growth can be attributed in part to the diversity of management and workforce.246

Several other studies have also demonstrated the material benefits of diversity to business performance. A 2018 report from McKinsey “reaffirms the global relevance of the link between diversity—defined as a greater proportion of women and a more mixed ethnic and cultural composition in the leadership of large companies—and company financial outperformance.”247 The McKinsey study also “found that companies in the top quartile for gender diversity in corporate leadership had a 21% likelihood of outperforming bottom-quartile industry peers on profitability. Leaders in racial and ethnic diversity were 33% more likely to outperform peers on profitability.”248 Similarly, a report from Refinitiv shows “the correlation between diversity and inclusion in the workforce and superior financial results.”249 Finally, the second iteration of a gender-focused Credit Suisse report examined “the link between gender diversity and superior company performance and how this is evolving over time.”250 The report mapped 27,000 senior managers at over 3,000 large, global companies, finding “clear evidence that companies with a higher proportion of women in decision-making roles continue to generate higher returns on equity, while running more conservative balance sheets.”

The following graphics, taken from the Credit Suisse study, illustrate the impacts to share price performance of having women on boards of directors and/or women in management:

246 Id.
As the link between diversity and performance continues to become clearer, regulatory pressure from states for public companies to diversify their boards and to report on their progress is growing as well. In late 2020, California enacted minimum requirements for diversity among boards of directors for companies incorporated in the state, and a handful of other states have taken similar legislative actions. Additionally, Nasdaq has filed a proposal with the Commission for “new listing rules [that] would require all companies listed on Nasdaq’s U.S. exchange to publicly disclose consistent, transparent diversity statistics regarding their board of

---

251 Id.
Alongside these regulatory developments, investor demands for more, better diversity information continues to provide consistent pressure on companies to respond. For example, the shareholder advocacy group, As You Sow, states on its website that 125 signatories representing $1.88 in AUM have signed onto their investor statement supporting enhanced disclosure of diversity information.

Some issuers are responding to investor demands for more diversity in the workplace and more information about how this is accomplished. Without specific reporting requirements, however, the disclosures have been disparate and inconsistent, as we discussed above. When EY analyzed 10-Ks following the recent changes to Regulation S-K, for example, it found that the most common theme discussed was diversity, equity, and inclusion (DE&I). “The majority had at least a qualitative discussion of the topic. More than a quarter of the companies [whose 10-Ks were reviewed] included a metric showing the breakdown of employees by gender. A similar number also included specific figures around ethnic diversity.” On the other hand, a recent Wall Street Journal analysis revealed that only “20 companies in the S&P 500, or 4%, fully disclose ethnic diversity in senior management, and only 17 companies fully report ethnic diversity at the board level.” In short, there’s still a wide information gap where this information is concerned.

As pressure mounts on all sides for more human capital-related information, and disclosures on this topic continue to proliferate, investors and issuers both need greater consistency, comparability, and assurances around the information that is being disclosed. As the Commission sets out to elicit disclosures covering the full scope of decision-useful, material ESG-related information, it should prioritize human capital-related metrics related to diversity and inclusion and discussions of management strategies and infrastructures to address this issue.

E. The Commission should adopt a variation on the “COSO model,” with more stringent SEC oversight and support from an expert advisory panel, to review and update ESG disclosure rules.

If, as we hope, the Commission acts to adopt mandatory ESG-related disclosures, it will need to consider how best to ensure that the required disclosures remain relevant and up-to-date. As senior SEC officials have acknowledged, one of the thornier issues the Commission will need to grapple with in this regard is whether it should retain responsibility for updating, improving, and augmenting any such disclosures over time or rely on one or more third party standard setters to fulfill that function. Keeping that responsibility in-house raises questions of resources, technical expertise, and the capacity of the Commission to keep pace with demands for updates and revisions in this dynamic and evolving issue area. Some have also raised concerns that it

255 Steve Klemash et al., How and Why Human Capital Disclosures are Evolving.
could make the standards more subject to political influence. However, delegating responsibility to a third party doesn’t entirely resolve those issues, and it raises separate concerns related to the potential for industry capture. Meanwhile, there are important strategic considerations that must also be taken into account as the Commission weighs what approach is likely to be most successful. Ultimately, the Commission may need to accept that there is no perfect solution to this dilemma and that any course of action it adopts will come with significant disadvantages, which it will need to do its best to mitigate.

Among those who favor at least some degree of reliance on a third-party standard setter, three basic approaches have been suggested: 257

- Having the SEC endorse the standards of an international standard setter, such as the one contemplated by the International Financial Reporting Standards (IFRS) Foundation. 258
- Creating a new U.S.-based sustainability standards board, operating under the oversight of the Financial Accounting Foundation (FAF) and endorsed by the SEC, to serve this purpose.
- Having the SEC set general ESG-related disclosure standards, and designate on a topic-by-topic basis, the third-party standard (or standards) companies could rely on to comply.

The first two are generally referred to as the endorsement model, in which the SEC “endorses” a particular set of standards in much the same way as it has recognized the financial accounting standards established by the Financial Accounting Standards Board (FASB). The latter is commonly referred to as the COSO model, as it follows the approach that the Commission used when it adopted rules for internal financial controls reporting and identified the COSO control framework as one that companies could use in establishing and testing their controls.

Advocates of these approaches tend to offer both general reasons why they believe the Commission should rely on one or more third-party standard setters as well as specific advantages and disadvantages of the various options. During a recent panel on this topic at a virtual roundtable hosted by New York University, for example, expert panelists including two former directors of the Division of Corporation Finance generally agreed that a third-party standard setter can be more responsive than the Commission to rapidly evolving ESG issues, can better address the wide range of topics that fall within the ESG sphere, and can better address the need for industry-specific standards. 259 Moreover, because these standard setters are not subject to the requirements of the Administrative Procedure Act, they can also act more quickly, when

---

257 For a discussion of the various options, see Session 3 of the NYU Law, Institute for Corporate Governance & Finance and NYU Stern Vincent C. Ross Institute of Accounting Research, Roundtable (April 30, 2021), recording available here: https://www.law.nyu.edu/centers/icgf/events. Panelists included former SEC Division of Corporation Finance Director Alan Beller, Council of Institutional Investors Executive Director Amy Borras, SASB CEO Janine Guillot, and former SEC Division of Corporation Finance Director John White.


259 See e.g., Comments of SASB CEO Janine Guillot at NYU Roundtable (generally); comments of Alan Beller at NYU Roundtable, (describing a standard setter as “a more flexible location for the development of a combination of cross-industry standards and industry-specific standards;” and saying, “[s]tandard-setters are not models of nimbleness, but they are models of nimbleness when you compare them to the regulatory structure.”)
needed, to update standards, while still maintaining a transparent process that includes broad input and consultation, due process, and cost-benefit analysis. They acknowledged, however, that the third-party standard setters have not always been as “nimble” as this might seem to imply. And investors have not always been as favorably impressed by the inclusiveness of their consultation process, as we discuss further below.

Those who believe SEC endorsement of an international standard setter is the best model argue that, with so many companies operating internationally, there is a compelling need for uniform global standards. Even enthusiastic advocates of this approach acknowledge, however, that this “would require an unprecedented level of cooperation.” The most likely outcome would be a “building blocks” approach, in which the global standard setter “comes up with a baseline of standards” – including the topics, metrics, qualitative and quantitative disclosures required – and each jurisdiction would have the ability to decide whether to opt out of or otherwise adjust those standards to meet their own needs. While some such differences may be necessary – to reflect, for example, the different labor laws and political systems that exist in different countries – others may have less substantive justifications. This suggests that SEC endorsement of an international standard setter might not result in the “single, global set of standards” its advocates offer as its primary benefit.

Moreover, such an approach faces significant headwinds. On the one hand, a global standard setter is unlikely to meet the standards for independent governance and funding that Congress established in the Sarbanes-Oxley Act as requirements for any accounting standard-setting body to be recognized by the SEC. That is one reason earlier SEC efforts to adopt the international accounting standards set by IFRS and the IASB, the international equivalents of FAF and FASB, never succeeded. It is also a major source of concern for even those investor groups, such as the Council of Institutional Investors, that have supported delegation of authority to a third-party standard setter. These groups have warned that any such body must adhere to the highest standards of independent governance and funding, and include robust representation for knowledgeable investors, in order to win their confidence. Such an approach also faces opposition from those who are unwilling to see the U.S. cede so much control to an international

---

260 Id. Beller (“The accounting standard setters are also, I think, clear evidence that you can have a standard-setting process that [allows for] wide input, broad consultation, due process, cost-benefit analysis ... IASB and FASB have shown they can do this [and you] could do the same with an ESG standard setter.”) Similarly, Guillot suggested that a third-party standard setter is better able than the SEC to incorporate market feedback and develop a consensus among investors in support of a particular approach.

261 Id. Beller. (“It’s really a question of doing this on a global basis ... The Holy Grail here really is a single, global set of standards.”)

262 Id. Beller.

263 Id. Beller, noting that this approach already exists in the European Union.

264 Id. Beller (“It’s still the case that there are formidable obstacles to global acceptance of a standard setter ... and U.S. acceptance of a global standard setter. One is the whole issue of governance, independence, funding. That was one of the reasons that IFRS came a cropper in the financial area.”)

265 Id. Borrus (Borrus identified adequate funding and an independent funding mechanism, balanced representation for investors on the staff, the board, and any outside monitoring and advisory groups, and some degree of public due process “to ensure that standards meet investors’ needs in a timely way.” “How do we know if we are comfortable with a global standard setter if it isn’t even established yet.”)
As former SEC Division of Corporation Finance Director Alan Beller stated at the recent NYU roundtable, “The level of representation that the U.S. would have in a global standard setter is less than the U.S. would politically and regulatorily find acceptable.”

In light of these concerns, advocates of a single standard setter model suggest that the SEC could achieve many of the same benefits by “standing up” a new U.S.-based ESG standard setter. As envisioned, such a board would operate alongside the FASB under the oversight of the FAF. This would, at least in theory, make it easier for the SEC to ensure that any such board meets the necessary standards of adequate and independent funding, independent governance, and robust representation for knowledgeable investors on not just the board, but also its staff and any advisory or oversight boards. CFA strongly agrees that these standards are essential to the board’s effectiveness and credibility, but experience suggests that they are easier to enumerate than to achieve. Moreover, we are not convinced that this approach will achieve the desired level of independence without fundamental reforms of FAF to include more investor representation.

An underlying assumption of those who favor delegation to an independent, third-party standard setter is that this process has worked well in other contexts to produce strong standards in a timely fashion. This is a view with which many investor advocates, including CFA, would strongly disagree. The history of FASB is particularly instructive in this regard, not least because advocates of delegation to a third-party standard setter often point to it as a model. Since FASB was created in 1972, the SEC has delegated to FASB responsibility for writing the Generally Accepted Accounting Principles that most companies are required to use when preparing their financial statements. Before FASB was created, this function was carried out by the Accounting Principles Board, a committee of CPAs working on a voluntary, part-time basis. At the time, the accounting profession was, in the words of the then President of the AICPA, “faced with a serious challenge to our ability to perform a mission of grave public

---

266 See, e.g., SEC Commissioner Hester M. Peirce, Rethinking Global ESG Metrics (Apr. 14, 2021), https://www.sec.gov/news/public-statement/rethinking-global-esg-metrics. (“[C]onverging standards would be antithetical to our existing disclosure framework, which is rooted in investor-oriented financial materiality and principles-based requirements to accommodate the wide variety of issuers. The European concept of ‘double materiality’ has no analogue in our regulatory scheme and the addition of specific ESG metrics, responsive to the wide-ranging interests of a broad set of ‘stakeholders,’ would mark a departure from these fundamental aspects of our disclosure framework.”)

267 NYU Roundtable Session 3, Beller. (Noting that the IASB includes two Americans among its 13 members, and IFRS trustees include three Americans out of 22. “I think the rest of the world thinks those numbers are about right [but I] don’t think U.S. policymakers would agree.”)

268 As enumerated by CII Executive Director Amy Borrus at the NYU roundtable.


270 However, PCAOB’s failure to adopt independent revised auditing standards in a timely fashion, and its continued heavy reliance on industry-set standards nearly two decades after the Board’s creation, offers another troubling example.

271 See, e.g., NYU Roundtable Session 3 discussion, generally.
responsibility.\textsuperscript{272} The goal of transferring this responsibility to FASB – a full-time board with a more broadly representative make-up – was to “attain better results faster.”\textsuperscript{273}

In the nearly 50 years since it was established, FASB has struggled, and too often failed, to live up to those early expectations. In testimony following the Enron failure, for example, former SEC Chairman Arthur Levitt stated that FASB had failed to keep pace with changing business practices, with the result that investors had not been given a clear picture of the company’s declining financial condition.\textsuperscript{274} He blamed that failure, and the fact that FASB’s decision-making process was “agonizingly slow,” at least in part on the fact that FASB was funded and overseen by accounting firms and their clients.\textsuperscript{275} Levitt called for changes to make FASB’s funding and oversight more independent, and less susceptible to influence, predicting that only then would FASB “be able to focus more on getting the standards right, and avoiding delays and compromises that ill-serve investors.”\textsuperscript{276} Though a number of steps were taken as part of the Sarbanes-Oxley Act to strengthen FASB’s funding and governance, the same long-standing complaints about the accounting standard-setting process remain today. In particular, investors continue to voice concerns that the board is both slow and dominated by auditors and corporate finance executives, who hold a majority of seats on the board.\textsuperscript{277}

As the Alliance of Concerned Investors (AOCI) stated in an October 2020 letter to the SEC, “investors have been ignored in the agenda-setting process” of FASB.\textsuperscript{278} Because FASB and FAF are dominated by preparers, according to AOCI, “the focus has shifted from what investors need to know to make informed decisions to an exercise where gatekeepers limit and control the amount of information preparers and auditors find it acceptable to release to investors.” In light of these concerns, AOCI has described FASB as showing signs of being “an entity in decline.” Separately, one of the nation’s leading investment management firms recently stated in a letter to the FAF that it does “not see the FASB to be effective in setting standards that meet investor needs for timely, complete, and relevant financial information.”\textsuperscript{279} This is a damning indictment of an organization that has been offered as a successful model of third-party


\textsuperscript{273} Id.


\textsuperscript{275} Id. (Ironically, when the Commission reaffirmed its policy of delegating this authority to FASB in 1973, it cited industry funding as “impressive evidence of the willingness and intention of the private sector to support FASB in accomplishing its task.” SASB Comment Letter at 10.)

\textsuperscript{276} Id.

\textsuperscript{277} See, e.g., Letter from the Alliance of Concerned Investors (Jane B. Adams, Jack Ciesielski, Rebecca McEnally, Janet Pegg, and Lynn Turner) to SEC Chair Gary Gensler et al. (Apr. 19, 2021).

\textsuperscript{278} Letter from the Alliance of Concerned Investors (Jane B. Adams, Jack Ciesielski, Rebecca McEnally, Janet Pegg, and Lynn Turner) to SEC Chair Jay Clayton et al. (Oct. 26, 2020).

\textsuperscript{279} Letter from Elizabeth Mooney, Partner, and Dane Mott, Accounting Analyst, Capital Strategy Research to Kathleen L. Casey, Chair, Financial Accounting Foundation, regarding Effectiveness of FAF and FASB (Apr. 9, 2021). Appendix.
delegation of standard-setting authority. It offers a timely warning to the Commission that it cannot simply assume that a standard setter established under the oversight of FAF would provide the timely, independent ongoing review of standards that advocates of this approach claim.

For these reasons, CFA and a number of others – including a number of former SEC officials from the Office of Chief Accountant – have called for reform of FASB and FAF to provide more robust representation for investors. These reforms to FAF and any board created under its auspices to set ESG standards would be essential to both its effectiveness and its credibility with investors. The individuals chosen to fill these investor slots should have an understanding of and extensive experience using financial reports and disclosures, expertise in ESG issues as they relate to investing, a commitment to transparent financial reports necessary for investors to make informed investment decisions, significant familiarity with the standard-setting process, and a record of serving the interests of investors and the public. Only then is it reasonable to assume that any such standard setter would be both effective in carrying out this task and responsive to investors’ needs. The SEC will need to determine, before pursuing such an approach, whether this is an attainable goal.

Questions have also been raised regarding the Commission’s legal authority, absent new authorizing legislation from Congress, to create such a board, set the terms for its operations and funding, and then delegate to it the responsibility for ESG standard setting. We have not attempted to assess the validity of that concern, and we recognize that there are respected securities law experts who believe the Commission does have that authority. What seems inevitable, however, is that any such effort would be subject to legal challenge by those whose goal is to prevent the Commission from adopting mandatory ESG disclosures. As a result, the inevitable delays involved in setting up such a board, combined with the delays while its legitimacy is challenged in court, could push back by a number of years the effective implementation of any such standards. If the political environment were to change in the interim, they might never be implemented at all.

See e.g., Comment letter from Janine Guillot, Sustainability Accounting Standards Board, regarding Climate Change Disclosures (May 19, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8819945-238161.pdf. It is worth noting, for example, that in looking around for an authority on the success of the third-party standard-setting process, SASB chose to quote a representative of the accounting industry rather than reflecting the less enthusiastic views of investors. See, SASB Comment Letter at 11, quoting Cynthia Fornelli, Executive Director, Center for Audit Quality, Testimony Before the United States House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises (March 12, 2009). (“Indeed, the independence, openness and due process of the FASB have long been recognized as, “important to ensure the legitimacy of the standards-setting process, and to protect the goals of transparency, relevance, and usefulness in financial reporting that have been hallmarks of decades of standards-setting efforts in the United States.”)

Jane B. Adams et al. Letter to Gensler.

With regard to funding and governance, the standards outlined in Section 108 of the Sarbanes-Oxley Act should be viewed as the minimum acceptable requirements. In light of persistent problems with FASB’s lack of focus on investor concerns, the Commission should not stop there.

NYU Roundtable, John White. (“My first question is, does the SEC have authority to do whatever it is we’re talking about, or does Congress need to do something?” White went on to state that doing this without going back to Congress would raise questions both about the SEC’s authority and the cost-benefit of its proposed approach.)
The so-called COSO model has been offered as an alternative that would enable the Commission to make use of the work of existing third-party standard setters without necessarily creating, or endorsing, a new ESG standard setter. 284 Under this hybrid approach, the SEC would engage in rulemaking to mandate disclosures related to a particular topic or set of topics, identify the issues to be covered, and establish some basic parameters for those disclosures. It would then, as part of that rulemaking, recognize one or more sets of existing standards that could be used to comply. 285 Under this approach, the SEC could, for example, “recognize” specific standards of SASB, or TCFD, the new international standard setter, or others. That standard would then be accepted for compliance with the rule unless and until the SEC were to withdraw that recognition. 286

We see significant problems with this approach, at least as envisioned by some of its supporters. It is suggested, for example, that under this approach the Commission could recognize the standards of multiple standard setters to satisfy compliance with disclosure requirements with regard to a single topic or subject area. And, indeed, when the Commission adopted its rules for management’s report on internal controls over financial reporting, it recognized three “suitable” control frameworks and encouraged “the further development of existing and alternative frameworks.” 287 Later, in response to intense lobbying from the issuer community, the Commission further watered down the requirements for management’s assessment of internal controls, when it released new interpretative guidance outlining a more “principles-based” and “flexible” approach to compliance. 288 In adopting this approach, the Commission brushed off concerns raised by investor groups that its proposed approach would undermine the quality of management’s assessments and the usefulness of their disclosures as well as their call for more explicit requirements for management to identify reporting risks and the controls designed to address them. 289

284 NYU Roundtable, White.
285 NYU Roundtable, White and Beller.
286 NYU Roundtable, Beller.
287 Securities and Exchange Commission, Commission Guidance Regarding Management’s Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (June 27, 2007), https://www.sec.gov/rules/interp/2007/33-8810.pdf. (FN 23: “In the Adopting Release, the Commission specified characteristics of a suitable control framework and identified the Internal Control—Integrated Framework (1992) created by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) as an example of a suitable framework. We also cited the Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants (“CoCo”) and the report published by the Institute of Chartered Accountants in England & Wales Internal Control: Guidance for Directors on the Combined Code (known as the Turnbull Report) as examples of other suitable frameworks that issuers could choose in evaluating the effectiveness of their ICFR. We encourage companies to examine and select a framework that may be useful in their own circumstance; we also encourage the further development of existing and alternative frameworks.”)
288 Id. at 48-49.
289 See e.g., SEC Final Rule, Release Nos. 33-8809, 34-55928; FR-76; File No. S7-24-06, Amendments to Rules Regarding Management’s Report on Internal Control Over Financial Reporting (Aug. 27, 2007) https://www.sec.gov/rules/final/2007/33-8809.pdf. (“For instance, three commenters suggested that the Proposed Interpretive Guidance does not contain specific, objective criteria that a company’s management could use to demonstrate that its evaluation complies with the requirements of the Proposed Interpretive Guidance. ... In light of these and similar concerns, one commenter suggested broadening the amended rule language to explicitly indicate that an evaluation provides a reasonable basis for management’s ICFR assessment if it includes: (1) an identification of the risks that are reasonably likely to result in a material misstatement of the company’s financial statements; (2)
If the Commission were to provide the same kind of flexibility with regard to ESG disclosures, it would not lead to the enhanced disclosure consistency investors are seeking. Instead, this approach could perpetuate investors’ main complaint about the existing voluntary disclosure environment – that it doesn’t result in disclosures that are consistent, comparable, and decision-useful. Experience with the internal controls rulemaking also suggests that this approach is no more protected from political influence than any other form of traditional Commission rulemaking. Despite these shortcomings, this hybrid approach – combining traditional SEC rulemaking with reliance on independent standards for compliance – may nonetheless represent the best available approach to ESG rulemaking. But it will only be successful if significant improvements are adopted to promote reliable, comparable disclosures that are responsive to the needs of investors. The following are among the key considerations the Commission will need to take into account to achieve this goal.

One of the most common complaints regarding the current voluntary disclosures is that the flexibility they provide does not result in the consistency that investors require. Under SASB’s voluntary regime, for example, companies determine for themselves “which SASB standard or standards are relevant to the company, which disclosure topics are financially material to [their] business, and which associated metrics to report.” Furthermore, they “may opt to disclose SASB data through a variety of channels, including annual reports to shareholders, integrated reports, sustainability reports, stand-alone SASB reports, regulatory filings, and investor relations websites.” They can omit or modify particular SASB metrics. When they do, they are encouraged, but not required, to disclose their rationale for doing so. This problem is exacerbated by the fact that, “As a standard-setting organization, SASB does not offer any type of compliance evaluation or certification for reporting companies.”

If the Commission were to rely on standards such as these, under an approach modeled on its approach to internal controls reporting, it would need to provide the consistency that these standards lack. It would need to specify, for example, where the disclosures are required to be provided and in what form. It would need to specify whether certain line item disclosures are: 1) required for all companies, regardless of materiality, 2) required only when they are financially material, or 3) required where it would be misleading to omit them. It would need to limit companies’ ability to adopt unnecessary and unwarranted modifications of the standards and require clear explanations behind the rationale and basis for any permitted modifications. And it

an evaluation of whether the company has placed controls in operation that are designed to address those risks; and
(3) a risk-based process for gathering and evaluating evidence regarding the effective operation of those controls.”
Ignoring those concerns, the Commission approved the guidance as proposed.

291 Id.
would need to back the requirements with enforcement. All of this would require that the Commission have some staff with relevant ESG expertise in both the regulatory and enforcement divisions. As former Corporation Finance Director Alan Beller said at the recent NYU roundtable, “They are going to have to staff up in order to review the 10Ks and 10Qs.”

Applying this model to ESG disclosures imposes an additional challenge that was less relevant in the internal controls context. As advocates of the endorsement model have noted, this is a broad and “dynamic” issue area, where standards are likely to be regularly revised, updated, and augmented. If the Commission adopts this approach, it will need to have a mechanism to monitor these changes in order to determine when new rulemaking is needed to adopt new disclosure requirements in a particular area, to revise existing rules, or to withdraw recognition of a particular standard, if necessary.

One mechanism for doing so could be the appointment of an advisory board, made up of experts across the range of stakeholders, to advise the Commission on new topic areas it should address and existing rules that may need to be revised. Members could include – in addition to investors, issuers, and accountants – federal regulators with relevant expertise (e.g., Environmental Protection Agency, Department of Energy, Equal Employment Opportunity Commission) or a direct stake in the disclosures (e.g., other financial regulators concerned with systemic risks to the financial system). While we recommend that such a committee, if created, have a broadly representative membership of respected experts, we strongly recommend that it have a majority of investor members and that an investor be appointed as chair. This would help to achieve another goal, not always reflected in the make-up and governance of the independent standard setters, that the recommendations reflect the needs of investors, in support of fair, orderly, and transparent markets.

While imperfect – as it would still depend heavily on the work of standard setters who are not held to the standards for independent governance, funding, and membership that are important to investors – this hybrid model may nonetheless represent the best option for the agency at this time. It could be adopted more quickly than an approach that requires standing up a new standard setter. It could, however, be adapted to recognize the standards of such a body if it were ultimately created. (If that new standard setter were established in keeping with the independent funding and governance requirements outlined by investors, that would help to address the initial concern regarding the potential for industry capture under this approach.) This hybrid model may also be less vulnerable to legal challenge than the endorsement model. It would make use of the extensive work already undertaken by the voluntary standard setters, but through a process of SEC rulemaking that would provide the consistency and reliability that these voluntary disclosures currently lack.

293 NYU Roundtable Session 3, Beller.
294 See, e.g., NYU Roundtable Session 3, generally.
295 It is important to note, however, that the Commission’s approach of relying on COSO and other independent frameworks for compliance with the rules governing management reporting on internal controls was never tested in court. While it seems highly likely to us that this approach would survive a legal challenge, if one were forthcoming, there is no specific precedent we can point to in support of that view.
F. The Commission must take steps to ensure the reliability of any new ESG-related disclosures.

In drafting any regulations to mandate climate and other ESG-related disclosures, the Commission will need to use all the tools available to it to ensure the disclosures are complete, accurate, and fairly presented. This concern with disclosure reliability should drive the decisions the Commission makes about where and how the disclosures are to be made, whether the information must be filed or furnished, and what level of assurance, if any, will apply. It will also demand a vigorous program of both regulatory oversight and enforcement by the Commission, and that will require both resources and staffing with relevant expertise.

Currently, with companies able to decide for themselves where and in what form to provide ESG-related information, the disclosures may be scattered among “annual reports to shareholders, integrated reports, sustainability reports, stand-alone SASB reports, regulatory filings, and investor relations websites.” Furthermore, as the Center for American Progress (CAP) noted in a recent report on the role of accounting and auditing in addressing climate change, “most companies that voluntarily issue climate reports present them in a way that makes it difficult to assess the company’s performance over time or to compare it to other companies.” The CAP report goes on to state that “it is often impossible for investors to discern how a company’s climate report relates to its financial statements. Climate reports tend to be replete with anecdotes and best-case scenarios. They are not audited, and auditors have no duty even to read them, much less evaluate whether the financial statements are consistent with the assertions in them.”

Promoting the reliability of ESG-related disclosures must start, therefore, with moving these disclosures into the existing SEC disclosure framework via amendments to Regulation S-K and Regulation S-X. There are good reasons to include the disclosures in Regulation S-K and Regulation S-X mandated filings. Many companies already include some ESG-related disclosures in such filings. For example, climate change disclosures may be found not only in the discussion of risk factors and the MD&A, but also in the description of business and the discussion of legal proceedings. Human capital disclosures are included in the description of business. New mandatory ESG-related disclosures should be designed to build on and improve the quality of those current disclosures. Some commenters have suggested that any such

disclosures should be confined to Regulation S-K. 300 We strongly disagree. Mandating climate or other ESG-related disclosures in Regulation S-X will help to ensure that companies must continue to disclose the financial and other business effects of their ESG-related decisions over time, which is essential if investors and other users of financial statements are to receive concrete and comparable information with which to make their decisions.

Moving the disclosures into required regulatory filings would make it easier to find and compare the information across companies. This important goal can be further supported by requiring the disclosures to be tagged. Tagging offers significant benefits to both institutional and retail investors. The former may be able to use the tagged data to set up proprietary systems to compare companies with regard to the issues of particular importance to them, whether those risks are related to climate risks, diversity and inclusion, or other ESG-related topics. Even retail investors who do not have the same capacity to conduct that analysis directly would still benefit from tagging if, as we expect, independent third parties use the data to analyze companies’ performance on ESG-related criteria and communicate their findings broadly to the investing public. By enhancing the ability to conduct cross-company comparisons, data tagging also helps to create more accountability around those disclosures.

Requiring the disclosures in mandatory disclosure documents would also trigger certain other safeguards that play important roles in ensuring the integrity of the disclosures. Chief among them is the requirement that disclosures made in the financial statements and footnotes to the financial statements be subject to an independent audit. As the CAP report on the role of accounting and auditing in addressing climate change states, “Unless a climate-related disclosure is included in the financial statements, it is outside the scope of the audit, which means it is not tested for accuracy, even if it is financial in nature.” 301 A well-conducted audit has the potential to bring greater rigor to the disclosures, because of the auditor’s “inside access to management records” and “opportunity to probe, test, and challenge all of management’s assertions” in the financial statements, “including both line items and footnote disclosure.” 302 Because of the critically important role entrusted to auditors to ensure the accuracy of financial disclosures, we urge the Commission, to the extent appropriate and feasible, to require ESG-related financial disclosures to be included in the financial statements and subject to an independent audit.

We recognize, however, that not all of the types of disclosures we believe are appropriate belong in the financial statements. Some may more appropriately be included in the Management’s Discussion and Analysis (MD&A) or some equivalent narrative component of the annual report. These disclosures are not required to be audited, and auditor attestation of the MD&A is optional under PCAOB rules. 303 Even where the disclosures are not required to be audited, however, putting them in the annual report should help to bring to the auditor’s attention issues that may be critically important to its assessment of management’s assumptions regarding the company’s financial condition and, in extreme cases, could even inform a going concern

---

301 Id.
302 Id.
303 Id.
In such circumstances, as the CAP report explains, “Auditors can play a key role in probing companies’ accounts in a way that disciplines disclosure and strengthens the through line from the physical risks of climate change and the economic impact of the global energy transition to the estimates that underlie the company’s current financial results and position.”

Despite its advantages, moving the disclosures into the 10K will not, in and of itself, ensure their reliability. They must also be subject to rigorous oversight and enforcement by the SEC. That has not always been the case. The CAP report sums the problem up well as it relates to climate disclosures, stating: “The SEC has recognized the sizable investor demand for climate-related information and has acknowledged that climate-related effects can be financially relevant—and thus, in each case, material to an investor. Yet it has not enforced its disclosure rules, either in financial statements, as required, or elsewhere (such as through mandated risk disclosures), effectively signaling that whether and what to disclose is up to a company’s board and management. For all intents and purposes, investors are left to their own devices—for example, through engagement with company representatives, the submitting of shareholder proposals, and proxy voting—to pressure companies to voluntarily publish climate reports.”

That sometimes lax approach to enforcement must not continue if the disclosures are to serve their intended purpose. Fortunately, the Commission has recently signaled that it intends to strengthen its oversight and enforcement, including through a stepped up review of climate-related disclosures by the Division of Corporation Finance, an increased focus on climate-related risks in the examinations conducted by the Division of Examinations, and the creation of a new task force within the Division of Enforcement focused on climate and other ESG issues. As announced, the initial focus of the task force “will be to identify any material gaps or misstatements in issuers’ disclosure of climate risks under existing rules.”

---

304 Ross, The Role of Accounting and Auditing.
305 Id.
306 Id.
307 Public Statement, Acting Chair Allison Herren Lee, Statement on the Review of Climate-Related Disclosure (Feb. 24, 2021), https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure. (“Today, I am directing the Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings. The Commission in 2010 provided guidance to public companies regarding existing disclosure requirements as they apply to climate change matters. As part of its enhanced focus in this area, the staff will review the extent to which public companies address the topics identified in the 2010 guidance, assess compliance with disclosure obligations under the federal securities laws, engage with public companies on these issues, and absorb critical lessons on how the market is currently managing climate-related risks.”)
308 Press Release, SEC, SEC Division of Examinations Announces 2021 Examination Priorities (Mar. 3, 2021), https://www.sec.gov/news/press-release/2021-39. (“This year, the Division is enhancing its focus on climate and ESG-related risks by examining proxy voting policies and practices to ensure voting aligns with investors’ best interests and expectations, as well as firms’ business continuity plans in light of intensifying physical risks associated with climate change,” said Acting Chair Allison Herren Lee. “Through these and other efforts, we are integrating climate and ESG considerations into the agency’s broader regulatory framework.”)
310 Id.
support these efforts. Unfortunately, as noted above, some ESG opponents have expressed concerns regarding the new, enhanced focus on enforcement. 311

As this discussion makes clear, investors cannot assume that the Commission will always provide the rigorous oversight and enforcement necessary to ensure ESG-related disclosures are complete, accurate, and fairly presented. In such circumstances, private liability can provide a necessary deterrent against lax compliance. As SEC officials in Republican and Democratic administrations alike have acknowledged over the years, private litigation provides an essential supplement to the Commission’s own enforcement efforts. 312 For private liability to serve as an effective deterrent, however, it is important that the required information be filed, rather than furnished. Requiring that disclosures be filed with the Commission comes with enhanced liability in the form of a separate private right of action under Section 18 of the Exchange Act (distinct from the more frequently asserted liability under Section 10-b). 313 Furthermore, information that is furnished, rather than filed, is not automatically incorporated by reference into the registration statements. As a result, information that is furnished may not be subject to the stricter liability standard that applies to registration statements. 314 Finally, information that is furnished is not subject to certain practices related to non-GAAP financial measures that are prohibited in SEC filings. 315 Thus, management’s accountability for the accuracy of those disclosures, while not entirely eliminated, is dramatically reduced when the information is furnished rather than filed. By generally requiring ESG disclosures to be filed with the Commission, rather than simply furnished, the Commission can help to ensure an appropriate level of accountability for the accuracy and reliability of these disclosures.

Some have argued that allowing the information to be furnished rather than filed is necessary to combat boilerplate disclosures. According to this argument, enhanced liability may lead companies to be overly cautious in their disclosures, using boilerplate, broadly applicable language to avoid any possibility of a misstatement or omission. According to this argument, allowing these documents to be furnished may incentivize companies to disclose with greater specificity than they might in a statement carrying greater liability risk. Others have argued that a furnishing standard, along with a safe harbor from 10b-5 liability, is also necessary to counteract the uncertainty inherent in some ESG disclosures (e.g., the uncertainty inherent in climate

311 See footnote 101, supra.
314 Id.
315 Id. (“[I]nformation that is “furnished”: … is not subject to the list of practices relating to non-GAAP financial measures that are prohibited in SEC filings by Item 10(e) of Regulation S-K (although with respect to Item 2.02 of Form 8-K other portions of Item 10(e) do apply, as discussed in more detail under “Reportable Events – Item 2.02”).”)

64
models). We disagree. While there may be some instances where it would be appropriate to adopt a requirement to furnish rather than file the information, any such exceptions to the filing requirement should be extremely limited. We would strongly oppose any safe harbor from fraud liability as inconsistent with the goal of improving the quality and reliability of current disclosures. Instead, the Commission should design its disclosures to avoid these problems by requiring, to the extent feasible, the disclosure of specific metrics that cannot be obfuscated through boilerplate.

G. The Commission should act to address “greenwashing” and “woke-washing.”

Amid rising societal concerns about climate change, racial injustice, and human rights abuses, ESG claims by asset managers have become a powerful marketing tool. As we discussed above, a growing percentage of retail investors have expressed an interest in investing based on environmental or other ESG issues. The primary way in which many of these retail investors are likely to do so is by investing in mutual funds or ETFs that claim to follow ESG principles. Concerns have been raised, however, about the legitimacy, consistency, and verifiability of those claims. Commissioner Peirce perhaps summed it up best in a 2020 speech: “Investors are pouring assets into ESG-labelled investment products, and asset managers are churning out new products in response. While the demand for these products is clear, less clear is what exactly these investors are buying.” Recent reporting suggests that at least some, and maybe a lot, of what they are buying wouldn’t match most investors’ views of what fits with the ESG label. That includes, for example, “sustainable” funds that have sizeable holdings of oil-and-gas companies “regularly slammed by environmental activists” or sustainable government bond funds with extensive holdings in Saudi bonds.

In a 2019 speech, Commissioner Peirce blamed the “nebulous nature” of ESG principles. “An adviser just needs to grab hold of something that allows it to show that it is managing according to ESG. A statement that you are an ESG manager may not require much to back it up. It may be enough to buy an ESG scorecard, hire a proxy advisor, or invest according to an index that incorporates an ESG filter.” While we believe that many ESG managers are engaged in

---

317 See discussion on pages 4-5 of this letter.
318 Wealthier investors may pursue ESG investing strategies by investing in private funds, which poses additional issues, since these funds are not required to provide the same types of disclosures as registered funds. We discuss that issue further below.
good faith efforts to invest consistent with what would generally be acknowledged as ESG values, the same may not be equally true of all. Even where there is a good faith effort to follow ESG principles, there can be perverse results that investors are unlikely to recognize. As the president of a “green” capital management firm stated with regard to sustainable funds that include oil-and-gas holdings, “Most investors don’t spend a lot of time looking under the hood. But I think if more knew that they were in fossil fuels, they’d think twice.”

Many have pointed to the ESG indices on which many ESG and sustainable funds are based as a source of such problems. This issue was particularly well documented in a 2019 Wall Street Journal article discussing JPMorgan’s JESG index of emerging-market dollar-denominated government bonds. According to that account, the fifth biggest holding of the fund are government bonds of Saudi Arabia, a country “which owns the world’s largest oil company, which restricts religious, sexual and many other freedoms, and which is an absolute monarchy whose agents cut up an opponent with a bone saw.” Because of the way the index is constructed, investors in funds based on that index “will actually end up with more in Saudi Arabia than a passive investor not paying attention to ESG.” One simple reason is that the creators of the index, having started from the Emerging Market Bond Index (EMBI), stripped out holdings tied to other countries viewed as having an even worse record, leaving Saudi Arabia with a larger percentage of the ESG version of the index.

Beyond that, however, the creators of the index weight the remaining countries according to their ESG scores and hold less of those with weaker scores. But the basis of those judgements is subjective, and can be difficult to fathom. As one analyst put it, “There’s no science at all.” The article notes that similarly inconsistent conclusions can be reached with regard to individual companies, depending on which factors one chooses to emphasize. “Tesla can be graded as the most environmentally friendly car company because its cars are electric, or as the worst for the environment because its factories are so inefficient.” It concludes that, “ESG scores differ in part because there is no right answer.”

Many members of the asset management industry have themselves recognized the problem. Recently, for example, the CFA Institute released an exposure draft of proposed ESG disclosure standards for investment products, on which it is currently seeking comment. CFA Institute launched the initiative to address a concern it had heard from market participants “that a great deal of confusion and misunderstanding exists with respect to ESG-related terminology and investment approaches and that this confusion may, over time, lead to an erosion of investors’ trust in the industry.” According to the CFA Institute, a vast majority of industry participants

323 Otani, ESG Funds Enjoy Record Inflows.
324 Mackintosh, Why Your Good Governance Fund is Full of Saudi Bonds.
325 Id.
326 Id.
327 Id., quoting Vikram Puppala, director of country risk research at Sustainalytics.
328 Mackintosh, Why Your Good Governance Fund is Full of Saudi Bonds.
330 Id. at 1.
(91%) who had reviewed an earlier consultation paper had agreed either without qualification (71%) or while expressing certain reservations (18%) that such a standard is needed.\textsuperscript{331}

It is not, in our view, appropriate for the Commission to dictate a particular strategy for funds that make ESG claims, any more than it would require all “growth” funds or all “value” funds to follow the same strategy. But the Commission does have an obvious role to play in ensuring that any such claims are not misleading and, further, that the funds clearly explain the principles and strategies that underlie their ESG-related strategies. It has reportedly had just such an effort underway for several years.\textsuperscript{332} More recently, the Commission has:

- Announced that its 2021 examination priorities for investment advisers and investment companies will include “investment strategies that focus on ESG factors,” with particular attention to “products in these areas that are widely available to investors including open-end funds and ETFs, as well as those offered to accredited investors such as qualified opportunity funds.”\textsuperscript{333} Examiners will “review the consistency and adequacy of the disclosures RIAs and fund complexes provide to clients regarding these strategies, determine whether the firms’ processes and practices match their disclosures, review fund advertising for false or misleading statements, and review proxy voting policies and procedures and votes to assess whether they align with the strategies.”
- Created a Climate and ESG Task Force in the Division of Enforcement that will, among other things, “analyze disclosure and compliance issues relating to investment advisers’ and funds’ ESG strategies.”\textsuperscript{334}
- Issued an Investor Bulletin on ESG funds that includes a warning that “all ESG Funds are not the same” and describing the wide range of practices that may be included under the ESG label.\textsuperscript{335}

CFA strongly supports these efforts.

We believe, moreover, that the current initiative to develop improved mandatory disclosures for climate and other ESG-related issues is a critical component in support of both these Commission efforts and voluntary efforts, such as the CFA Institute’s ESG standard-setting initiative, to bring greater clarity to such claims. Improving the information companies are required to provide will make it easier for asset managers to develop credible ESG strategies and for the SEC to hold them accountable for the ESG-related claims they make. Of course, improved issuer disclosures related to ESG factors can never eliminate inconsistencies in funds’ ESG strategies entirely, nor should that be the goal. There should always be room for asset managers to adopt different ESG strategies consistent with their different views about which

\textsuperscript{331} Id.
ESG-related issues are most important and how to weigh different factors. But improved issuer disclosures should provide asset managers with a better foundation for those strategies and help them to more clearly convey those strategies. That, in turn, should enable third parties (e.g., Morningstar) to analyze the effectiveness and validity of those strategies and convey that information in a way that is likely to be most useful to the investing public.336

H. Other aspects of our regulatory framework needed to support effective ESG disclosures are in urgent need of repair.

Mandatory issuer disclosures exist within a broader ecosystem of securities regulations designed to support investors’ ability to rely on the information disclosed and incorporate it into their investing and voting decisions. For example, we require an independent audit of financial statements in order to ensure that this snapshot of a company’s financial condition and operations is complete and accurate and prepared in accordance with GAAP. When issuers provide disclosures that are inaccurate or misleading, investors who suffer financial losses as a result have the ability to hold companies and their executives accountable in court and seek to recover those losses. As shareowners, investors have the right to submit and vote on proposals seeking to reform company operations, and they rely on company disclosures and, in some instances, the recommendations of proxy advisors to inform their votes. In each of these areas, however, the regulatory protections that are intended to support investors’ investing and voting decisions are in urgent need of repair.

An even more serious failing in our current system is the extent to which capital raising and debt financing have moved out of the transparent public markets and into the private markets, where few if any disclosure requirements may apply. That is a fundamental shift never anticipated by the authors of the original federal securities laws, who sought to ensure that issuers would have to disclose all the “essential facts” necessary to value those securities if they were to be sold to members of the general public. Today, however, trillions of dollars are raised through equity and debt offerings that operate outside that regulatory regime. These private securities are sold to investors, including in some cases retail investors, with few if any mandated disclosures. Unless the Commission acts to address that problem, its efforts to improve ESG disclosures will be, at best, a partial success.

Even as it moves forward with rulemaking to mandate improved ESG disclosures, therefore, the Commission will need to find the resources to tackle these issues as well. The following is a brief overview of the reforms we believe are needed in these areas.

1. Audits of public companies need to be more independent and rigorous.

Auditors have been entrusted with the critically important, and extremely lucrative, responsibility for ensuring that public companies’ financial statements are complete, accurate, and prepared in accordance with GAAP. They also have additional, more limited responsibility for reviewing certain non-GAAP disclosures. As such, they have a potentially important role to play in ensuring that any new mandatory ESG disclosures are accurate and reliable. For auditors to fulfill this function effectively, they need to have relevant expertise, and they need to approach

336 As noted above, their ability to do so will be significantly enhanced if the disclosures are required to be tagged.
their task with an appropriate degree of independence and professional skepticism. Indeed, it is the independence of audits, and the professional skepticism that grows out of that independence, that gives audits their value.

Unfortunately, both auditor independence and professional skepticism have too often been in short supply, as PCAOB inspections results from recent years have documented. In its Inspections Outlook for 2019, for example, PCAOB states: “Over the last several years, we have identified recurring deficiencies related to auditor independence, including firms’ monitoring procedures failing to identify independence violations. These recurring deficiencies suggest that some firms and their personnel either do not sufficiently understand applicable independence requirements or do not have appropriate controls in place to prevent violations.” Violations found at both the largest firms and at smaller firms have included: a failure to have adequate systems in place to provide investors with confidence that the audit firm was in fact complying with the independence rules; and evidence that auditors were misleading audit committees by failing to provide them with the information they need to make informed decisions. In a related matter, inspection staff have also continued “to raise concerns about whether some auditors appropriately apply professional skepticism in the course of their audits, particularly in those areas that involve significant management judgments or transactions outside the normal course of business, as well as the auditor’s consideration of fraud.” In other words, where skepticism is most needed, auditors are too often falling down on the job.

Instead of responding to this evidence of a fundamental problem at the heart of public company audits with heightened oversight and tough enforcement, the PCAOB and SEC have in recent years taken a number of steps to weaken both the auditor independence rules and the PCAOB’s oversight of public company audits. For example, the PCAOB adopted new guidance in 2019 that permitted firms to claim an audit was independent and conducted in accordance with PCAOB standards even when violations of the auditor independence rules occurred. Both the

337 PCAOB, Inspections Outlook for 2019 (Dec. 6, 2018), https://pcaobus.org/Inspections/Documents/InspectionsOutlook-for-2019.pdf. See also, PCAOB, Staff Inspection Brief Vol. 2017/4 (Nov. 2017), https://pcaobus.org/Inspections/Documents/inspection-brief-2017-4-issuer-results.pdf (“Inspections staff continued to identify deficiencies related to non-compliance with PCAOB rules and/or SEC rules and regulations related to auditor independence. Examples include instances in which auditors: …conclude[d] inappropriately that a covered person’s lack of independence … had not resulted in impairment of the firm’s independence; … Entered into agreements through which their audit client agreed to indemnify the auditor against any liability or expense arising out of the engagement; Provided impermissible non-audit services during the period under audit … Some deficiencies were also identified that indicated certain firms did not have a quality control system that provided sufficient assurance that outside firms or auditors involved in issuer audit engagements or the firm’s personnel were in compliance with the independence requirements.”).  
SEC 340 and the PCAOB 341 subsequently weakened the auditor independence rules and did so, in the case of the PCAOB, without providing any opportunity for public comment. At the same time, leadership at the PCAOB, with the apparent support of the SEC’s Office of Chief Accountant, reduced the budget, including for its critically important inspection function. 342 Audit-related enforcement actions by PCAOB and SEC have also seen a steep decline. 343 As a result, a broad coalition of investors, former SEC officials, former members of various PCAOB advisory groups, asset managers, unions, and academics have called for a top-to-bottom overhaul of this critically important regulatory body. 344

The Commission recently announced a shake-up in the leadership of the PCAOB. 345 This is an essential first step toward restoring the Board’s credibility in the eyes of investors. However it is just the first step. Once new leadership has been installed, the SEC Office of Chief Accountant must work with the agency and the Commission to restore the PCAOB’s budget, to install high-level staff with the experience and commitment to the public interest necessary to the job, and to refocus the Board on increasing the frequency and rigor of inspections, backing them up with strong enforcement, and reinventing the standard-setting process to focus on audit standards that have been identified by investors as priorities for revision and updating. In addition, both the SEC and the PCAOB should revisit the recently adopted changes to the auditor independence rules and instead consider whether additional steps are needed to strengthen and promote compliance with those standards.

As we discussed above, auditors have the potential to play an important role in ensuring the accuracy and reliability of companies’ ESG disclosures. Absent sweeping reforms of both auditor oversight and auditor independence rules, however, they cannot be relied on to bring

344 Jane B. Adams et al., Letter to Chair Gensler and Former PCAOB IAG Member Letter.
sufficient rigor to that role, particularly as it relates to the critically important task of evaluating the management assumptions that underlie certain of these disclosures.

2. Companies need to be accountable to shareholders regarding the accuracy of their disclosures.

As we discussed above, private litigation offers an important supplement to SEC enforcement as a means to ensure companies’ disclosures are accurate and not misleading. But shareholder litigation rights have come under attack in recent years. That has come, in part, in the form of proxy proposals from an anti-litigation shareholder activist to require all securities claims to be decided individually in arbitration.\(^{346}\) Although one such proposal at Intuit was voted on and soundly defeated,\(^{347}\) an earlier SEC opinion that Johnson & Johnson could exclude the issue from its proxy ballot\(^{348}\) has been undermined by a subsequent Delaware Supreme Court decision.\(^{349}\) That decision, often referred to as the Blue Apron decision, raised the possibility that forced arbitration clauses could be adopted through bylaw or charter amendments without any opportunity for a shareholder vote.\(^{350}\) If efforts such as this were to succeed, investors would, for all practical purposes, lose their ability to pursue securities fraud claims for misleading corporate disclosures.\(^{351}\) Among other reasons, the costs of bringing such claims (e.g., discovery, expert witnesses) make it impractical to pursue them individually in arbitration. Meanwhile, that same Blue Apron decision has been used successfully by companies in a few instances to preclude investors from bringing claims under federal securities laws even when no state law remedy was available.\(^{352}\)

Legislation has been introduced in Congress that would address the forced arbitration issue for both retail investors’ disputes with their financial professionals and shareholder securities fraud claims.\(^{353}\) We strongly support this legislation, and urge the Commission to work


with the bill sponsors to secure its passage. However, we believe a broader legislative response may be needed to address the full implications of the Blue Apron decision. We urge the Commission to work with supporters in Congress to develop an appropriate legislative response. These strengthened protections for shareholder litigation rights are urgently needed to provide an added deterrent to misleading disclosures, including with regard to ESG.

3. The proxy process needs to be accessible to all investors, and investors need to be able to get reliable information on which to base their voting decisions.

One way in which investors can be expected to use new ESG disclosures is to support and inform their votes on ESG-related shareholder proposals. As we discussed above, ESG-related issues are a major focus of recent shareholder proposals, with interest in and support for proposals related to environmental and social issues on the rise. But the Commission in the last administration took steps to greatly constrain the ability of shareholders, particularly retail investors, to offer such proposals. And it simultaneously adopted rules undermining their ability to get independent advice to support their proxy voting decisions. These rules will need to be reversed or extensively revised if investors are to get the full benefit of new ESG disclosures.

Recently, Chair Gensler announced that he had directed the staff “to consider whether to recommend further regulatory action regarding proxy voting advice,” and in particular, “whether to recommend that the Commission revisit its 2020 codification of the definition of solicitation as encompassing proxy voting advice, the 2019 Interpretation and Guidance regarding that definition, and the conditions on exemptions from the information and filing requirements in the 2020 Rule Amendments, among other matters.” At the same time, the Division of Corporation Finance issued a statement in which it indicated that it will not recommend enforcement action to the Commission based on the 2019 Interpretation and Guidance or the 2020 Rule Amendments during the period in which the Commission is considering further regulatory action in this area and while litigation challenging the rules is pending.

We strongly support these actions as an important step toward restoring investors’ ability to get proxy voting advice that has not been unduly influenced by company management. We urge the Commission to undertake a similar effort with regard to the shareholder proposal rules.

---


4. With private markets having dramatically expanded, the Commission must act to ensure broader application of the disclosure requirements.

When Congress adopted the original federal securities laws in the 1930s, their underlying assumption was that any securities sold to the general public would be accompanied by full disclosure of all the essential facts needed to value those securities. That has long since ceased to be the case. Today’s private equity markets dwarf the public equity markets in terms of both the number of offerings and the amount of capital that is raised, and private debt markets rival (and may have surpassed) the public debt markets in size.358

![Figure 1. Aggregate capital raised in 2009-2017 by offering method (Sbillions)](https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf)

*Other private includes Regulation S offerings, Section 4(a)(2) offerings, Regulation Crowdfunding offerings, and Regulation A offerings.

Some of those raising capital in these markets are the innovative new companies we are led to picture when we talk about the importance of private markets to small company capital formation. However, one of the most notable changes in the private markets since the JOBS Act was adopted in 2012 is the extent to which companies today are able to grow to enormous size, with a significant potential impact on the economy, without conducting a public offering or providing ongoing disclosures. According to one statistics portal for market data, for example, there were 288 so-called unicorns (private companies valued at $1 billion or more) in the United

358 Scott Bauguess et al., Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017, SEC Division of Economic and Risk Analysis (August 2018), https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf. Because this study is several years old, we believe it is possible that private debt markets have since surpassed the public debt markets in size, but it can be difficult to obtain reliable information.
States as of April of this year, up from just 40 in 2013. Similarly, the 144A market is dominated by public companies issuing private debt. Meanwhile, the dominant users of private offering exemptions in the equity markets aren’t individual companies at all, but large private funds, including private equity and hedge funds. These exempt offerings, including Regulation D offerings to relatively wealthy retail investors, are not subject to “the comprehensive disclosure requirements that apply to registered offerings.”

There are many reasons why CFA opposes this broad expansion of the private markets, as we detailed in recent comment letters to the Commission. There is no logic, in our view, to basing our disclosure requirements on the method of raising capital, or issuing debt, rather than on something more closely tied to a company’s or offering’s impact on the economy, such as the company’s valuation, its revenues, or the number of its employees. The current threshold for becoming a publicly reporting company, which is tied to the number of shareholders, has been so watered down in recent years that it no longer serves its intended function of identifying those companies whose shareholders are sufficiently numerous and dispersed to warrant the full disclosure required in the public markets. But one practical effect in the current context is that, absent Commission action to close these loopholes in our disclosure-based regulatory regime, much of the capital raised and debt issued in our markets would be exempt from any new ESG disclosure rules.

One step we urge the Commission to take to address this problem is to amend the definition of shareholder of record under Section 12(g) of the ‘34 Act to include all the actual beneficial owners of the shares. This would be an important step toward requiring all large companies, whether public or private, to be publicly reporting companies. While this change could be adopted relatively quickly through rulemaking, further action may nonetheless be needed to truly ensure that all larger companies are required to provide the robust disclosures that their size and potential impact on the economy warrant. One approach is to look at additional steps to bring more companies into the public markets, which we strongly support. We have written about this extensively elsewhere, and we continue to believe this should be a

359 Statista, Number of unicorns worldwide as of April 2021, by country, https://www.statista.com/statistics/1096928/number-of-global-unicorns-by-country/ (last visited June 9, 2021). The U.S. total is more than twice the total in the second-ranked country, China with 133, and nine times the total in the third-ranked country, India at 32.
priority for Commission action. Another possible approach the Commission should consider is whether to impose additional disclosure obligations in the private markets. This could involve rulemaking under Rule 144A, Rule 506 of Regulation D, and possibly Regulation AB to mandate disclosures for large private offerings.

Should the Commission choose to pursue the latter approach, we believe there are good reasons why at least certain ESG factors should be included among those that have to be disclosed. Allowing companies the choice of whether to be transparent creates an opportunity for regulatory arbitrage. It would enable large companies that engage in practices that are environmentally harmful, or involve human rights violations, or contribute to racial injustice, to hide those practices from public view, giving them a competitive advantage over their more transparent public market competitors. Furthermore, if the Commission maintains this disclosure imbalance, it will only intensify the incentive for public companies to rely on exempt debt offerings to fund operations that are inconsistent with their public statements, including statements regarding their commitment to combating climate change. That would not only deprive their investors of information they would find material to their investment decision, it would also undermine fair competition. As discussed above, however, SEC mandated disclosures are relied on by more than just investors. Maintaining this disclosure imbalance between public and private equity and debt offerings by large companies would also make it more difficult for financial institutions to assess the risks or impacts of financing their operations and more difficult for regulators to assess their compliance with the law.

There is another reason to improve ESG-related disclosures in the private market. As discussed above, private funds, including both hedge funds and private equity funds, increasingly claim to adopt an ESG focus in their portfolios. But without reliable ESG-related disclosures for the private companies they invest in, their ability to pursue those strategies and investors’ ability to hold them accountable for pursuing such strategies will be severely limited. To combat the potential for greenwashing in the private fund market, the Commission should go a step further and require private funds that make ESG claims to back those claims with evidence of how they incorporate ESG factors into their investment strategy. Only then will investors be able to make an informed choice.

Currently, our regulations require transparency and accountability in the public markets while providing companies with unlimited ability to raise capital in the private markets, including from retail investors who, by any reasonable definition, do not have the ability to fend for themselves in these opaque and loosely regulated transactions. That puts both investors and the health of our public markets at risk. As the Commission acts to bring greater transparency to our public markets with regard to ESG factors that are not only material to investors but essential to the fair and orderly function of our markets, it must ensure that it doesn’t intensify the incentives for companies to avoid that transparency and accountability by remaining private or relying on exempt offerings to issue debt. It can tackle that problem either by adopting policies that force more companies into the public markets, by enhancing disclosure requirements for large private offerings, or through some combination of the two approaches.

364 For example, we urge the Commission to withdraw the recently adopted changes to the integration doctrine, which appear to be designed to make it easier for companies to avoid a public offering. See, Roper and Hauptman Facilitating Capital Formation Letter at 6-14.
Conclusion

The Commission has an opportunity to bring the federal securities law disclosure framework into the 21st century by incorporating the information about climate change and other ESG factors that retail and institutional investors alike are increasingly demanding. Doing so is not only well within the Commission’s authority, it is necessary to achieve the Commission’s mission of protecting investors, promoting fair and orderly markets, and capital formation. We look forward to working with you to achieve this important goal.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

Dylan Bruce
Financial Services Counsel