Federated Hermes

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Submitted via Electronic Mail

The Honorable Gary Gensler
Chair
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Request for Public Input Regarding Climate Change Disclosures

Dear Chair Gensler:

Federated Hermes, Inc. ("Federated Hermes") appreciates the opportunity to submit comments in response to the Securities and Exchange Commission's ("SEC" or "Commission") March 15, 2021 request for public comment regarding "whether and how" the Commission's disclosure rules should be modified to ensure "consistent, comparable, and reliable information on climate change"[1] ("RFI").

Federated Hermes is a leading global investment management firm, managing through our advisory subsidiaries $625 billion in total assets as of March 31, 2020. Federated Hermes provides comprehensive investment management to more than 11,000 institutions and intermediaries, including corporations, government entities, insurance companies, foundations and endowments, banks, and broker/dealers.

Federated Hermes is a global leader in active, responsible investment management. We are guided by the conviction that responsible investing is the best way to create long-term wealth. As a leader in ESG investment integration, Federated Hermes uses material ESG factors as part of a full range of analytical factors in evaluating investments. Our goal is to use these metrics to reduce risk and to improve returns.

Given our role as a global investment firm and our extensive experience with ESG-integrated investment processes, we support the SEC's efforts to carefully evaluate and calibrate its existing disclosure rules with respect to climate change-related risks and opportunities that are material to issuers and investors. To that end, we urge the Commission to (1) build upon its principles-based disclosure regime; (2) focus on material disclosures; and (3) maintain the global competitiveness of U.S. capital markets. We firmly believe that consistent, comparable, and reliable financially

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[1] Allison Herren Lee, Cmr., Securities and Exchange Commission, *Public Input Welcomed on Climate Change Disclosures* (Mar. 15, 2021).

material disclosures are critical to the long-term success of the United States' capital markets, which are the most liquid and efficient in the world.

Build Upon the Commission's Principles-based Disclosures Regime

As the Commission considers the public comments to the RFI and its next steps in "evaluat[ing] its disclosure rules with an eye toward facilitating the disclosure of consistent, comparable, and reliable information on climate change,"[2] we urge the Commission to consider a hybrid approach where a principles-based disclosure regime is supplemented with certain prescriptive elements that are applicable if material.

Currently, U.S. securities law is a principles-based disclosure regime, rather than a prescriptive regime as has been implemented in other countries. A principles-based disclosure regime is superior to a prescriptive regime because it provides for flexibility and context~~;~~, avoids inundating investors with unhelpful information~~;~~, and is more easily modified in light of experience and the dynamic nature of climate risks and ESG considerations. Such a system promotes an orderly and efficient market that enables an efficient allocation of capital that appropriately matches issuers with investors. Federated Hermes believes strongly that the U.S. public capital markets are more liquid, orderly, and secure than other capital markets because they are protected by a principles-based disclosure framework rather than a prescriptive disclosure regime. Accordingly, the SEC should build on this existing regime to promote consistent, comparable, and reliable financially material climate change-related disclosures from issuers of registered securities.

We believe that an effective climate change disclosure system could focus on comprehensive, straight-forward qualitative disclosures in Form 10-K and, as necessary, Form 10-Q, as required by the Forms and Regulation S-K. Risks specifically could be disclosed in "Part I, Item 1A: Risk Factors" of Form 10-K, and supplemented as necessary in Part II, Item 1A: Risk Factors of Form 10-Q, to avoid confusion or counterintuitive placement. The Commission could also permit companies to satisfy any applicable ESG disclosure requirements by making the relevant information widely available, such as through a Form 8-K; on the company's website; or through a separate, publicly-filed report.

We recommend serious consideration of an industry-by-industry approach to such disclosures. The challenges and opportunities of climate change, including physical and transition risk and opportunity, vary considerably by industry.[3] Issuers and investors, like Federated Hermes, as well as other market participants, would be better served by a flexible disclosure system that takes industry features into consideration, rather than a one-size-fits-all approach, as some disclosures may not be material to certain issuers and/or in certain industries (we discuss materiality further in the next section). If disclosures are business-line specific, it will be even more important for any

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[2] *Id.*

[3] "Moreover, the economic and financial market impacts of climate-related risks vary across geographies, sectors, and jurisdictions and depend importantly on the existence of feedback loops." Lael Brainard, Governor, Federal Reserve Board, *The Role of Financial Institutions in Tackling the Challenges of Climate Change* (Feb. 18, 2021). See also Hester Peirce, Cmr., Securities and Exchange Commission, *Rethinking Global ESG Metrics* (Apr. 14, 2021) ("Unlike financial accounting, which lends itself to a common set of comparable metrics, ESG factors, which continue to evolve, are complex and not readily comparable across issuers and industries."

rules and guidance to allow for an issuer-by-issuer and industry-by-industry approach so that investors can obtain the information they need.

As discussed in more detail by the Investment Company Institute (ICI),[4] the SEC should also look to the Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board's climate-related standards for guidance. As noted by the ICI, "investors—including fund managers—have increasingly sought ESG information from companies that is 'decision useful,' helpful in guiding complex, daily choices by fund managers who are tasked with investing for the benefit of their shareholders and in accordance with the fund's own objectives and disclosures."[5] To this end, the TCFD has appropriately recommended that issuers disclose "actual and potential impacts of climate-related risks and opportunities on the company's businesses, strategy, and financial planning, <u>where such information is material</u>." (emphasis added).

Some commenters may urge the Commission to opt for a prescriptive, metrics-based climate change-related disclosure policy, rather than the Commission's existing, historical, effective principles-based disclosure framework. We believe a hybrid approach where the disclosure regime is principles-based but has certain prescriptive elements would be most effective. We acknowledge that prescribed metrics, such as the disclosure of Scope 1 and Scope 2 emissions under the TCFD, can help foster comparability and consistency with respect to certain climate change-related information. However, we caution the SEC against replacing the current principles-based disclosure framework in favor of establishing a prescriptive regime for the reasons discussed above and for the following additional reasons:

First, designing and reporting on climate change-related metrics may not provide the precision and clarity proponents believe they will. Federal officials have recognized the difficulty of establishing such metrics and raised concerns that such metrics may not capture the material information intended.[6]

Second, a metrics-based disclosure system may lack the necessary context and information provided in a principles-based framework. Situating any metric in the context of a narrative and complementary qualitative data is important for investors to assess the metrics properly and to obtain the full picture. Reliance on metrics that are not as precise as believed and reviewing them with insufficient context may lead to mismatches between investments and investors, resulting in both harm to investors and disorderly markets. Also, many metrics may not be useful across issuers and/or industries, resulting in investors receiving extra data that does not assist their decision-making. Further, such metrics may have difficulty capturing the cost-benefits of climate-related

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[4] *ICI Supports Biden Administration's Approach Toward Fostering Better Climate Risk Disclosure from Companies*, Investment Company Institute (Apr. 22, 2021).

[5] *ICI Board Unanimously Calls for Enhanced ESG Disclosure by Corporate Issuers*, Investment Company Institute (Dec. 7, 2020).

[6] "Estimates of the magnitude of climate-related financial risks are highly uncertain…the long time horizon associated with climate change, the lack of historical data, the potential for sudden shifts in asset valuations, and the paucity of information on the climate-sensitivity of exposures complicate the translation of climate-related risks into measures of credit, market, liquidity, reputational, and operational risks." Lael Brainard, Governor, Federal Reserve Board, *The Role of Financial Institutions in Tackling the Challenges of Climate Change* (Feb. 18, 2021).

opportunities. Certain metrics also may be difficult for issuers to measure or subject to alternative means of measurement or interpretation.

Third, a prescriptive regime is much more difficult to adjust in light of experience, technological advancement, and structural economic changes than a principles-based approach. Once a metric becomes outdated, the Commission will be placed in a difficult position of deciding when a critical mass of metrics is outdated before commencing the rigorous rulemaking process needed to adjust those metrics. In the interim, issuers will be forced to track and measure outdated metrics, and investors will receive information that is not material and, therefore, not decision-useful. A principles-based approach, on the other hand, provides much more flexibility, enabling the disclosure framework to organically evolve as issuers and investors respond to important economic and societal changes. Moreover, fine-tuning a flexible regime is easier than reworking specific quantitative metrics.

Fundamentally, a principles-based disclosure approach is superior to a prescriptive, metrics-based approach because it is more flexible, provides more depth and context, is easier to revise, and is less prone to disseminating information that is not as precise as believed or lacks usefulness. These features are particularly important for climate change disclosures given the current challenges to quantitative measurement. While prescribed metrics should supplement the principles-based regime, as prescription can help bring about comparability and consistency across industries, such prescribed disclosures should be grounded in materiality to ensure investors are not burdened with filtering out irrelevant or overly-detailed information that hinders informed decision-making.

Focusing on Materiality

In addition to building climate change disclosures into the SEC's existing principles-based disclosure regime, we advise the Commission to tie disclosure requirements to the existing materiality standard.

The Supreme Court first established the concept of materiality in 1976[7] and further refined it in 1988.[8] This standard still exists and has served issuers, investors, and the U.S. public capital markets well for almost fifty years. As climate change-related risks and opportunities become more prevalent across most (if not all) industries, we urge the SEC to develop a regulatory framework that makes clearer which climate change-related information is material to a particular industry and therefore required to be disclosed under the federal securities laws. The materiality standard is critical to enabling issuers to disclose, and investors to receive, decision-useful information. This is particularly important for investment managers like Federated Hermes as we exercise our fiduciary duty on behalf of clients. Thus, it should be the foundation of climate change-related disclosures.

We caution against a rulemaking that would mandate disclosure of non-material climate change-related disclosures because such information is not decision-useful to investors. In our experience, non-material information does not improve due diligence; on the contrary, it raises costs by imposing greater demands on the time needed to review the information that is disclosed. More

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[7] TSC Industries v. Northway, Inc., 426 U.S. 438 (1976).
[8] Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

disclosure of material information is helpful, but more disclosure simply for the sake of providing more disclosure is not helpful~~,~~ to investors, especially to smaller or retail investors who may not have the ability to effectively digest or compare a large number of disclosures quickly.

Ensuring that material disclosures are provided, while curbing "data dumps" of non-material information, is also important to promoting efficient allocation of capital to companies that are actually dedicated to managing their ESG risks. As previously discussed, we consider ESG factors in our investment processes as part of a full range of analytical factors in evaluating investments in order to reduce risk and to improve returns. Studies show that this integrated use of ESG factors actually improves investment outcomes for participants and other investors. For example, in what is likely the most comprehensive survey of the available studies, the Journal of Sustainable Finance and Investment found that "...the business case for ESG investing is empirically very well founded. Roughly 90% of studies find a nonnegative ESG–[Corporate Financial Performance] relation."[9] Moreover, Bank of America found that companies with better ESG characteristics performed better financially, while those with poor ESG characteristics posed higher risks for themselves and for investors.[10] However, such investment processes are effective only if investors have access to an issuer's material ESG information. Some issuers may provide non-material climate change-related information in an attempt to attract capital from investors using ESG strategies or considering ESG factors to improve performance. This foreseeable risk should be curbed through a disclosure regime centered on materiality, which would help prevent investors from being overwhelmed by unhelpful ESG information and, consequently, less able to identify and invest in issuers that are actually dedicated to managing their ESG risks.

Maintaining the Global Competitiveness of U.S. Capital Markets

Finally, we believe that any climate change-related disclosure regime must be designed with an eye toward maintaining the U.S. public capital markets' global competitiveness. We are well acquainted with the competing disclosure requirements in other countries. It is our experience that the U.S. regulatory regime facilitates competitive capital markets due to its principles-based, materiality-focused disclosures that are not burdensome to comply with, and protect investors in a cost-efficient manner while providing decision-useful, comparable information. While we support modifying existing disclosure rules, even with some prescriptive metrics, to reinforce the requirement to disclose, and specifically elicit, material climate change-related information, we are conscientious of the risk of reducing the competitiveness of U.S. capital markets with competitor markets by raising costs, both for issuers in having to track and measure prescribed metrics and investors in having to review disclosed information. Avoiding the pitfalls of a purely prescriptive, metrics-based approach will help retain U.S. public capital markets' competitiveness while promoting more efficient capital allocation.

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[9] "ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies," Journal of Sustainable Finance and Investment (2015). The Journal reviewed the primary and secondary data of previous academic review studies, combining the findings of roughly 2,200 individual studies.

[10] "ESG from A to Z: A Global Primer," Bank of America (Nov. 25, 2019).

Conclusion

Federated Hermes firmly believes that consistent, comparable, and reliable financially material climate change-related disclosures will help investors make prudent investment decisions. Providing additional guidance on required disclosures also will assist issuers in providing meaningful climate change-related information when it is material to them. Accordingly, we urge the Commission to (1) supplement, not replace, its principles-based disclosure regime with prescriptive metrics; (2) focus on material disclosures; and (3) maintain the global competitiveness of U.S. capital markets.

We hope that the Commission finds these comments helpful and constructive. We can provide additional information relating to our comments or discuss any questions you may have.

Sincerely,

Peter J. Germain
Chief Legal Officer

cc: The Honorable Hester M. Peirce
The Honorable Elad L. Roisman
The Honorable Allison Herren Lee
The Honorable Caroline Crenshaw
John Coates, Acting Director, Division of Corporation Finance