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The Failure of ESG: *An Examination of Environmental, Social, and Governance Factors in the American Boardroom and Needed Reforms*

Staff Report | ESG Working Group

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Table of Contents

I. EXECUTIVE SUMMARY 4
II. BACKGROUND AND KEY PRIORITIES 5
III. INTRODUCTION 7
IV. THE PROBLEM: AN ENVIRONMENT RIPE FOR ABUSE 8
1. The Politicized Proxy Voting System 8
A. The Rule 14a-8 No-Action Letter Process 10
B. The Shareholder Proposal Submission and Resubmission Processes 11
2. The Outsized Role of Proxy Advisory Firms 12
A. Reversal of Clayton-Era Proxy Voting Advice Rules 13
B. Prioritizing ESG Factors Over Financial Performance 14
C. Little Transparency or Accountability 14
D. Inaccurate Information in Proxy Advisory Firm Reports 15
3. Institutional Investors: The Role of Fiduciaries 15
A. Examining Fiduciary Responsibilities 16
B. Inconsistent Proxy Voting Determinations 16
C. Empowering Investors 17
4. The Influence of Large Asset Managers 17
A. The Power of the Big Three 18
B. Regulatory Gaps: Ownership and Control 18
5. ESG Raters and their Impact on U.S. Public Companies 18
A. Lack of Standardization and Transparency 19
B. Negative Impact on U.S. Public Markets 19
6. A Politicized SEC 20
A. Undermining the Materiality Standard 21
B. Climate Risk Disclosures 22
C. Human Capital Management Disclosure 24
D. SEC Rule 14a-8 No-Action Letter Process 24
E. Other ESG-Related Initiatives 25
7. The Extraterritorial Impact of EU Disclosure Regulations on U.S. Public Companies 25
A. The Burdensome Effects on U.S. Companies 25
B. The Failure of the Biden Administration to Defend U.S. Interests 26
8. State Regulations 26
V. THE WAY FORWARD: CONGRESS AND THE COURTS 27
1. The Courts 27
A. The United States Supreme Court: Limitations on Agency Rulemaking 28

B. The National Association of Manufacturers: Challenging SEC Proxy Process Fouls.......28

C. ExxonMobil: Challenging Bad Faith Activists.......29

D. The Climate-Related Disclosure Rules: Plagued with Legal Challenges.......30

2. Targeted Legislative Action.......32

A. H.R. 4767: The Protecting Americans' Retirement Savings from Politics Act.......32

B. H.R. 4790: The Guiding Uniform and Responsible Disclosure Requirements and Information Limits (GUARDRAIL) Act of 2023.......34

C. H.J.Res. 127: Providing for Congressional Disapproval of the Climate Disclosure Rule .35

D. H.R. 4655: The Businesses Over Activists Act.......35

3. Congressional Oversight: The House Financial Services Committee.......35

A. SEC Climate Disclosure Investigation.......35

B. Proxy Advisory Duopoly.......36

C. Fiduciary Responsibility of Asset Managers.......37

I. EXECUTIVE SUMMARY

On February 3, 2023, shortly after the start of the 118th Congress, Chairman Patrick McHenry of the United States House Committee on Financial Services announced the creation of the Environment, Social, and Governance ("ESG") Working Group. The Working Group was led by Oversight and Investigations Subcommittee Chairman Bill Huizenga and was designed to coordinate a response to the troubling increase in efforts to force progressive policies on the private sector. The Working Group met with a series of stakeholders to identify factors that have allowed this increase to occur. It also identified reforms that address problems caused by activist-led ESG initiatives, which are designed to ensure American capital markets remain the envy of the world.

The Working Group identified several factors that have contributed to a rise in ESG-related initiatives, which often promote unpopular, progressive policy objectives that cannot pass through the appropriate legislative channels. For example, the U.S. Securities and Exchange Commission ("SEC") has added challenges around the shareholder proxy process that have fostered an increase in progressive activism. Specifically, the SEC has, among other things, implemented Staff Legal Bulletin No. 14L, which prevents companies from excluding shareholder proposals that raise certain social policy matters—even if those policy matters are not material to the company. As a result, companies are forced to spend their limited time, money, and attention considering an increasing number of activist-led proposals that do nothing to increase shareholder value.

The SEC has also overstepped its statutory authority by finalizing a climate disclosure rule, which exploits the securities regulatory and disclosure frameworks to advance the Biden Administration's climate policy goals. Despite the SEC's changes to the rule before it was finalized, the rule remains an onerous, costly, and ineffective means to dictate climate policy. Unfortunately, the SEC is not the only one inappropriately exploiting these frameworks to achieve climate policy goals. For example, California—the largest state in the country—has adopted rules that are more burdensome, and even farther reaching, than the SEC's rule.[1] Likewise, the European Union has advanced climate-related corporate disclosure directives that would apply to American businesses for activities that occur within the United States.[2]

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1. *See* Cal. SB 261, the Greenhouse Gases: Climate-related Financial Risk Act, *available at* https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240SB261; Cal. SB 253, the Climate Corporate Data Accountability Act, *available at* https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202320240SB253; Cal. Assembly Bill 1305, the Voluntary Carbon Market Disclosure Act, *available at* Bill Text - AB-1305 Voluntary carbon market disclosures.
2. *See* EU Website, Corporate sustainability reporting, *available at* https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en; *see also* Patrick Spath, Jakob Tybus, Tim Bartels, Morrison Foerster Client Alert, *What you should know about the CS3D and Forced Labor Regulation and Their Impact on Your Business Activities, available at* https://www.mofo.com/resources/insights/240620-what-you-should-know-cs3d-forced-labor-regulation#_ftn-ref1.

Fortunately, the courts have stepped in to protect against certain cases of extreme regulatory overreach. For example, in *Loper Bright Enterprises v. Raimondo,*[3] the Supreme Court overturned its decision in Chevron *U.S.A., Inc. v. NRDC,* sending a powerful reminder to agencies like the SEC that their authority is not unlimited.[4] Additionally, the Fifth Circuit recently agreed with the *National Association of Manufacturers* that SEC acted "arbitrarily and capriciously" by rescinding certain aspects of a rule affecting unaccountable proxy advisory firms two years after those rules were finalized[5] and before they had even taken effect.[6] There are also strong legal arguments in favor of those challenging the SEC's climate disclosure rule.[7] The Working Group is increasingly hopeful that efforts to overturn the rule, which Congress never authorized the SEC to finalize in the first place, will be successful.

The Working Group also identified several policies that address problems caused by activist-led ESG-initiatives. Among these reforms, Congress should reform the proxy process by, among other things, increasing the thresholds required to re-submit unpopular shareholder proposals and unwinding the policy set forth in Staff Legal Bulletin No. 14L. Likewise, Congress should pass legislation making proxy advisory firms more accountable. For example, proxy advisory firms should be required to register with the SEC, appropriately manage their conflicts of interest, make detailed disclosures, and be responsible for any material misstatements. Additionally, institutional investors (such as mutual funds, index funds, and pension funds) should not be allowed to engage in the practice of "robo-voting", nor should the SEC exceed its statutory authority by finalizing rules (such as the climate disclosure rule) which mandate non-material disclosures of non-economic information.

II. BACKGROUND AND KEY PRIORITIES

The ESG Working Group was created at the start of the 118th Congress to protect the financial interests of everyday investors from radical activists who weaponize existing securities regulatory and disclosure frameworks to implement far-left policy objectives. The Working Group, consisting of select Republican members of the House Committee on Financial Services, met with a range of prominent and well-informed stakeholders to analyze the impact of these activists' efforts and develop solutions to ameliorate the ideological fervor that is harming investors and our markets. This report (hereinafter, the "Final Report") continues and expands

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3. *See Loper Bright Enters. v. Raimondo*, No. 22-4751, 2024 WL 3208360 (U.S. June 28, 2024).
4. *Id.*
5. *Nat'l Ass'n of Mfrs. v. SEC*, No. 22-51069, 2024 WL 3175755, at * 10 (5th Cir. June 26, 2024).
6. *Id.*, at *7-9.
7. Certain of these arguments are summarized here: Paul Davies, Sarah Fortt, and Betty Huber, Latham & Watkins LLP, *The Case Against the SEC's Final Climate Rules Begins in Earnest (and What It Means)*, HARV. LAW. SCH. F. ON CORP. GOV., Apr. 20, 2024, *available at* https://corpgov.law.harvard.edu/2024/04/20/the-case-against-the-secs-final-climate-rules-begins-in-earnest-and-what-it-means/ (Please note that this was written prior to so-called Chevron deference being overturned by the Supreme Court); *see also* the arguments enumerated *infra* on pages 27-28 of this memorandum.

upon the goals and objectives the Working Group first presented in the Preliminary Report. The Final Report summarizes current ESG-related trends and analyzes relevant legal and policy matters. It also provides updates on existing and proposed policies, including policies or legislative items that were not in effect at the time of the Preliminary Report. Consistent with the Working Group's key priorities (as set forth below), the Final Report also recommends reforms that address problems caused by activist-led ESG-related initiatives.

Key Priorities

- Reform the proxy voting system to safeguard the interests of retail investors.
- Promote transparency, accountability, and accuracy in the proxy advisory system.
- Enhance accountability in shareholder voting by aligning voting decisions with the economic interests of shareholders.
- Increase transparency and oversight of large asset managers to ensure their practices reflect the pecuniary interest of retail investors.
- Improve ESG rating agency accountability and transparency to safeguard retail shareholders.
- Strengthen oversight and conduct thorough investigations into federal regulatory efforts that would contort our financial system into a vehicle to implement climate policy.
- Demand transparency, responsibility, and adherence to statutory limits from financial and consumer regulatory agencies.
- Protect U.S. companies from burdensome European Union ("EU") regulations, safeguarding American interests in global markets.

III. INTRODUCTION

The continued prioritization of ESG initiatives[8] by the Biden Administration is a deliberate strategy to circumvent the lack of congressional support for progressive environment and social policy measures. In many cases, these measures are falsely portrayed as advancing financial returns or being necessary for investor protection. Faced with their inability to pass problematic policy initiatives through traditional legislative channels, the administration and other activists have weaponized the securities regulatory and disclosure frameworks to impose their radical agenda on the private sector.

Efforts to advance progressive ESG-related objectives have occurred at the international, federal and state levels. For example, California—the largest state in the Union (and the 5th largest economy by GDP in the world)—recently enacted ESG-related policies that are politically motivated and economically unsound. By mandating Scope 3 greenhouse gas emissions, California's Climate Corporate Data Accountability Act exceeds the initiatives of the Gensler-led U.S. Securities and Exchange Commission ("SEC") and exacerbates challenges for companies already struggling to comply with domestic and international regulations.

To address these expanding concerns, the Working Group operated under a two-part mission to:

- Examine the implementation of a far-left ideological agenda on businesses and investors; and
- Identify solutions to protect investors and our capital markets from this misaligned and divisive agenda.

The Preliminary Report analyzed key themes and shed light on critical areas, such as the use of the shareholder proposal process by a small group of activists to advance political and social objectives at the expense of other investors. It also addressed the undue influence on shareholder voting exerted by proxy advisory firms. Additionally, the Working Group raised concerns about the SEC[9] exceeding its statutory authority by mandating non-material climate-related regulations and making harmful changes to the proxy process that facilitate exploitation by liberal activists. These findings were synthesized in the Preliminary Report, which was presented to Republican Members of the House Committee on Financial Services, and subsequently released to the public, on June 23, 2023.

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[8] For purposes of the discussion and analysis in this Final Report, the Working Group defines "ESG" as a fund, corporate, or regulatory focus on so-called broad corporate social responsibilities and non-pecuniary measures, including in the form of environmental, social, governance, or political factors.

[9] The Department of Labor also published a final rule published in the Federal Register in December of 2022, entitled, "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights." Notable, the Department of Labor has taken the position that, "ERISA does not preclude fiduciaries from making investment decisions that reflect environmental, social, or governance (''ESG'') considerations, and choosing economically targeted investments (''ETIs'') selected in part for benefits in addition to the impact those considerations could have on investment return." *Available at* https://www.govinfo.gov/content/pkg/FR-2022-12-01/pdf/2022-25783.pdf. But for purposes of this memorandum, we have restricted our analysis to the SEC and not specifically other federal agencies.

This Final Report reemphasizes and reaffirms the Working Group's strategic focus and continues to engage along that same trajectory, as the issues contemplated in the Preliminary Report have only expanded in scope. This Final Report aims to buttress the Preliminary Report's findings with a deeper exploration into recent developments, including the climate-related initiatives pursued by independent agencies such as the SEC. The Final Report then concludes with policy recommendations that respond directly to problems identified by the Working Group this Congress.

IV. THE PROBLEM: AN ENVIRONMENT RIPE FOR ABUSE

Throughout this Congress, the Working Group has uncovered an ecosystem, where unelected bureaucrats and private sector activists force progressive ESG policies on the private sector. For example, progressive stakeholders exploit an ambiguous proxy process to promote shareholder proposals that prioritize unsound environmental and social policy goals above shareholder returns. Similarly, unregulated and unaccountable proxy advisory firms rely on their clients' cost, time, and other restraints to recommend votes that largely favor progressive corporate governance initiatives. Regulators at the state, federal, and international levels have all contributed to this problem by implementing unpopular, and sometimes illegal, regulations that burden companies and harm retail investors.

Part IV of this Final Report discusses each of the elements that comprise the elaborate but interconnected ESG ecosystem in greater detail. It includes a section that summarizes why ESG investing has been hard to define but has resulted in lower returns for investors without accomplishing the liberal policy goals that activists often promote. It also includes sections describing problems with the proxy voting process and the role of proxy advisory firms, institutional investors, and ESG rating agencies. It concludes with sections summarizing ESG policies and other initiatives led by regulators at the federal, state, and international levels.

1. The Politicized Proxy Voting System

SEC rules generally require public companies to issue a proxy statement that provides shareholders with information about proposals being considered at annual shareholder meetings.[10] Initially intended to democratize shareholder oversight, the proxy process has been overtaken by activist shareholders pushing liberal policy objectives, which no longer helps firms maximize long-term shareholder value. Unrestrained shareholder activism diverts attention and resources away from core business matters, eroding the appeal of U.S. markets and discouraging companies from pursuing public offerings.

The Gary Gensler-led SEC has exacerbated this problem by promulgating changes that facilitate politically motivated shareholder proposals in proxy statements while rolling back key reforms to proxy solicitation rules. Consequently, ESG initiatives are often advanced at the expense of good governance and investor returns. For example, in 2021, SEC changes led to a significant rise in environmental and social proposals, with a 46 percent increase in environmental proposals in 2022 compared to 2021.[11]

[10] 17 C.F.R. § 240.14a-3.
[11] *See* Brigid Rosati, Kilian Moote, Rajeev Kumar, & Michael Maiolo, Georgeson LLC, A Look Back at the 2022

According to Institutional Shareholder Services ("ISS"), the substantial increase in environmental and social proposals has led to public backlash, with average support for these proposals significantly declining.[12] For example, in 2023, out of 625 environmental proposals submitted, only eight received majority shareholder support, down from 39 in 2021 and 37 in 2022.[13] This trend continues in 2024, with environmental and social proposals receiving little shareholder support.[14] As support for ESG shareholder proposals wanes, a record number of anti-ESG shareholder proposals were filed in 2023,[15] indicating growing shareholder fatigue with non-pecuniary measures by a vocal, ideologically-driven minority.

While some critics of ESG proposals argue that the increase in anti-ESG proposals reflects a healthy marketplace of ideas, they overlook the time and cost associated with these proposals. The inclusion of non-material shareholder proposals does not "democratize" corporate governance but rather allows a vocal minority to prevail over a larger, less organized majority. Even if these proposals are defeated, existing SEC rules allow for their re-proposal in substantially the same form after a short period of time has elapsed.

At minimum, non-material ESG proposals represent a costly abuse of the proxy process, forcing companies to misallocate resources away from profit-driven activities. Chair Gensler's use of the SEC as a political tool is deeply concerning, risking the investments of hard-working Americans and sets a dangerous precedent of weaponizing the agency for progressive purposes. The SEC should not place ideology over the primacy of shareholder returns, nor should it turn public companies into a political football where public boards would have to contort themselves into pretzels to ensure they do not run afoul of the latest political winds—a concept antithetical to how public corporations should be run.

Moreover, these costs are not just borne by companies but by their investors, particularly the millions of retail investors who rely on their investments for retirement. The SEC expects each investor to read every proxy statement and make informed decisions. With hundreds of ESG proposals filed annually, each investor would need to spend 30 minutes considering each proposal. Multiplied by millions of investors, this results in a massive time burden and cost on average retail investors. This excessive time commitment detracts from their ability to make informed investment decisions and undermines the primary goal of maximizing shareholder value.

To demonstrate the dangers facing public companies from the current abuse of the shareholder proxy process, consider Comcast in 2022. Politicized investors proposed that the

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Proxy Season, HARV. LAW. SCH. F. ON CORP. GOV., Oct. 23, 2022, *available at* https://corpgov.law.harvard.edu/2022/10/23/a-look-back-at-the-2022-proxy-season/.

[12] *See* ISS Insights, 2023 United States Proxy Season Review: Environmental & Social, Dec. 29, 2023, *available at* https://insights.issgovernance.com/posts/2023-united-states-proxy-season-review-environmental-and-social/.

[13] *See Id*.

[14] ISS Corporate, Pro-ESG Shareholder Proposals Regaining Momentum in 2024, May 22, 2024, *available at* https://www.iss-corporate.com/library/pro-esg-shareholder-proposals-regaining-momentum-in-2024/.

[15] See ISS Insights, 2023 United States Proxy Season Review: Environmental & Social, Dec. 29, 2023, *available at* https://insights.issgovernance.com/posts/2023-united-states-proxy-season-review-environmental-and-social.

company report on its retirement plan options in relation to climate action goals.[16] Although this attempt to use retiree funds for political purposes failed, it could have resulted in lower returns or higher risk for investors if successful. Similarly, other proposals, such as demanding a racial equity audit from Home Depot[17] or climate targets from Costco,[18] have no material impact on financial performance. In more extreme cases, proposals are offered in bad faith to disrupt a company's operations, such as activists' proposals calling for ExxonMobil to accelerate carbon dioxide emissions reductions designed to interfere with the company's business model.

As ESG proposals grow in number, even as they decline in shareholder support, investors face enormous risk. Studies show that ESG proposals tend to harm financial returns. Research demonstrates a correlation between increased activism by public pension funds promoting social agendas and lower stock returns, resulting in a 14 percent decrease in valuation for affected companies.[19] Moreover, these extraneous ESG proposals impose substantial costs on companies and their shareholders, without holding the proponents accountable. The term "ESG" has become so politicized that one of its original prominent proponents, BlackRock's Chairman and CEO Larry Fink, has ceased using it.[20]

The proxy voting system needs reform to strengthen shareholder engagement, promote transparency, and eliminate inefficiencies. The system must be modernized to enhance corporate governance and ensure that it operates in the best interests of shareholders. The following subsections discuss specific aspects of the proxy voting system, including changes to the no-action letter process and resubmission thresholds, which have made it easier for activists to force companies misallocate resources from profit-driven activities.

A. The Rule 14a-8 No-Action Letter Process

The rise in the number of ESG-related shareholder proposals can be attributed, in part, to ambiguities caused by the SEC in the Rule 14a-8 no-action letter process.[21] For example, in November 2021, the SEC issued new guidance that made it difficult for companies to exclude

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[16] *See* Costco Wholesale Corporation., 2022 Proxy Statement, *available at* https://www.sec.gov/Archives/edgar/data/909832/000090983221000017/costproxy2021.htm#i2f7c340eb4a542eb97726625d070c9cc_918.
[17] *See* The Home Depot Inc., 2022 Proxy Statement, *available at* https://www.sec.gov/Archives/edgar/data/354950/000035495022000116/hd-2022proxystatement.htm#ic093c1edc810406d92fceac310f5482e_106
[18] *See* Costco Wholesale Corporation., 2022 Proxy Statement, *available at* https://www.sec.gov/Archives/edgar/data/909832/000090983221000017/costproxy2021.htm#i2f7c340eb4a542eb97726625d070c9cc_918.
[19] *See* Wayne Winegarden, *Proxy Advisory Firms and the ESG Risk*, FORBES, Jul. 25, 2022, *available at* https://www.forbes.com/sites/waynewinegarden/2022/07/25/proxy-advisory-firms-and-the-esg-risk/?sh=50290d8012d1..
[20] *See* Isla Binnie, *BlackRock's Fink says he's stopped using 'weaponised' term ESG*, REUTERS, June 26, 2023, *available at* https://www.reuters.com/business/environment/blackrocks-fink-says-hes-stopped-using-weaponised-term-esg-2023-06-26/.
[21] Companies may informally engage SEC staff to advise on whether the SEC would seek an enforcement action if the company excluded a shareholder proposal from its annual proxy. If the SEC agrees with the company's arguments that there is a sound basis for exclusion, the SEC will grant no-action relief, and the company may exclude the proposal without fear of an enforcement action.

ESG shareholder proposals.[22] More specifically, Staff Legal Bulletin No. 14L stated that the SEC will focus on the social policy significance of issues raised by shareholder proposals, rather than an individual company's connection to the particular issue. As ESG shareholder proposals become harder to exclude under Chair Gensler's leadership, activist stakeholders are emboldened to offer a greater number of unreasonable ESG-related shareholder proposals.

As it becomes harder to exclude ESG shareholder proposals under Staff Legal Bulletin No. 14L, companies may become less likely to seek no-action relief. At a 2023 meeting of the American Bar Association's Business Law Section, the SEC's Division of Corporation Finance Chief Counsel admitted that the SEC had only been asked to respond to 177 no-action letter requests, a 25 percent drop from the prior year.[23] While the number of requests for Rule 14a-8 no-action relief have increased in 2024, to ensure the 2024 uptick is not an aberration, changes to the no-action letter process remain necessary.[24] The no-action letter process has become a mechanism for SEC staff to project its views about the "significance" of non-securities issues, rather than a process for ensuring shareholder-proponents' interests are aligned with those of their fellow shareholders. To address this concern and promote greater accountability, it is crucial that Congress revise the SEC no-action letter process.

B. The Shareholder Proposal Submission and Resubmission Processes

Shareholder proposals come with significant costs, demanding valuable time and resources from the company's management and board. Legal advice, engagement with shareholders, SEC communications, printing, mailing, and vote tabulation costs contribute to these significant expenses. Parodically and unfairly, it is the company and all of its shareholders who bear these costs, with costs borne only marginally by the shareholder-proponent. This disconnect must be addressed.

Under current SEC rules, even small shareholders who meet a $2,000 ownership requirement for at least three years can submit proposals on public company ballots.[25] This process is exploited by activists driven by social and/or political agendas, leading to an increasing number of ESG-related shareholder proposals and reproposals. Moreover, given the significant influence of proxy advisors, companies are unable to exclude repeat ESG-related proposals, regardless of whether shareholders have previously rejected them.[26] As a favorable recommendation from a proxy advisor firm can easily garner 25 percent investor support,

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[22] *See* Staff Legal Bulletin No. 14L (Nov. 3, 2021), *available at* https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals.

[23] *See* TheCorporateCounsel.net posted by Liz Dunshee, *Shareholder Proposals: No-Action Stats & Reminders*, May 10, 2023, *available at* https://www.thecorporatecounsel.net/blog/2023/05/shareholder-proposals-no-action-stats-reminders.html.

[24] Shareholder Rights Group, *SEC No Action Statistics to May 1, 2024*, Sanford Lewis, General Counsel, *available at* https://www.shareholderrightsgroup.com/2024/05/sec-no-action-statistics-for-2024.html.

[25] Previously, shareholders were required to have continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to vote on the proposal for at least one year by the date the proposal is submitted. Today, the following thresholds apply: $2,000 for at least three years; $15,000 for at least two years; and $25,000 for at least one year. *See* Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8, 17 CFR 240.

[26] Under SEC rules, a company may exclude a shareholder proposal from its proxy materials if (among other requirements) the proposal received: less than 5% of the vote if proposed once within the preceding five years; less

shareholder proposals backed by proxy advisors can be resubmitted indefinitely, even if they do not serve the long-term interests of companies and retail investors and have continually been rejected in shareholder votes.[27]

Under Chair Gensler's leadership, the SEC has further impeded the ability of companies to exclude previously rejected shareholder proposals. On July 13, 2022, the SEC proposed amendments to Rule 14a-8(i)(12) that would impose additional restrictions on companies seeking to exclude proposals that address substantially the same subject matter as prior proposals which received minimal support.[28] These proposed changes will only make it easier for activists to resubmit previously rejected proposals. Reforms are, therefore, necessary to ensure effective shareholder engagement can be maintained, and the rights and interests of all shareholders can be protected.

2. The Outsized Role of Proxy Advisory Firms

In general, investors are provided voting rights with their purchase of shares in publicly traded companies. Despite the growth in retail participation in our public markets, institutional investors (such as mutual funds, index funds, and pension funds) continue to vote their shares at a significantly higher rate than everyday investors.[29] In many cases, these institutional investors own shares in hundreds of publicly traded companies.[30] Due, in part, to the considerable time and costs associated with voting these shares, institutional investors' proxy voting decisions are often influenced or determined by the advice and recommendations of proxy advisory firms.

In recent years, the outsized influence of proxy advisory firms on the proxy voting system has become a growing concern. Proxy advisory firms, such as ISS and Glass Lewis, have gained an unprecedented level of control – commanding 97 percent of the market. Their dominance raises serious questions about bias and accountability, as these firms have the power to sway institutional investors' voting decisions.

This level of influence undermines the fairness and transparency that underpins corporate governance. The increasing influence of proxy advisors can be attributed to several factors. First, these firms provide recommendations on how institutional investors should vote on various shareholder proposals. Institutional investors lack the time and resources to conduct extensive research on every proposal and rely on the recommendations and guidance of proxy advisors as a

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than 15% of the vote on its last submission to shareholders if proposed twice previously within the preceding five years; or less than 25% of the vote on its last submission to shareholders if proposed three times or more previously within the preceding five years. *Id.*

[27] *See* James Copland, David F. Larcker & Brian Tayan, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry* (Stan. U. Graduate Sch. Bus., Research Paper No. 18-27, 2018), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3188174.

[28] *See* Substantial Implementation, Duplication, and Resubmission of Shareholder Proposals Under Exchange Act Rule 14a-8, Exchange Act Release No. 34-95267 (Jul. 13, 2022), *available at* https://www.sec.gov/rules/proposed/2022/34-95267.pdf.

[29] *See* James Copland, David F. Larcker & Brian Tayan, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry* (Stan. U. Graduate Sch. Bus., Research Paper No. 18-27, 2018), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3188174.

[30] Raj Gnanarajah & Gary Shorter, Cong. Rsch. Serv., IF11221, Introduction to Financial Services: Corporate Governance 1 (2020).

result. Second, the rise of passive investing has further amplified the impact of proxy advisors, as they often dictate voting decisions for a significant portion of shares held by passive funds. Therefore, the following subsections discuss the policies that have allowed proxy advisors' influence to go unchecked. They also discuss the harm these firms cause to investors and our markets.

A. Reversal of Clayton-Era Proxy Voting Advice Rules

In July 2020, the SEC made much-needed amendments to its rules on proxy solicitations. These changes were directed toward ensuring that proxy advisors disclose any conflicts of interest they may have and provide their clients with more comprehensive and accurate information when making voting decisions.[31] The SEC emphasized that proxy voting advice may count as a solicitation under proxy rules. As a result, any omission of material information regarding proxy voting advice could be a violation of the proxy rules' antifraud provision.[32]

The adopted amendments were intended to enhance the ability of proxy voting advice users, including investors and their representatives, to make informed voting decisions without any unnecessary costs or delays that could negatively affect the timely delivery of proxy voting advice.[33] For instance, the amendments introduced some procedural safeguards regarding the provision of proxy advice, such as "engagement policies" that would require proxy advisors to interact with issuers. These policies were put in place to ensure that clients of proxy advisors receive transparent, accurate, and complete information to make well-informed voting decisions.[34]

Less than two months into his tenure, Chair Gensler directed SEC staff to make a recommendation on whether the Commission should reconsider the 2020 reforms on proxy voting advice businesses and the Commission's longstanding interpretation of proxy solicitation.[35] Following Gensler's directive, SEC staff announced that it would not recommend enforcement actions pursuant to the adopted 2020 rule.[36] The SEC then proposed amendments

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[31] *See* SEC Release, *SEC Adopts Rule Amendments to Provide Investors Using Proxy Voting Advice More Transparent, Accurate and Complete Information* (Jul. 22, 2020), *available at* https://www.sec.gov/news/press-release/2020-161; *See Exemptions from the Proxy Rules for Proxy Voting Advice*, Rel. No. 34-89372 (Jul. 22, 2020), *available at* https://www.sec.gov/rules/final/2020/34-89372.pdf.

[32] *Id.*; *See* Commissioners Elad Roisman and Hester Peirce, "Response to Chair Gensler's and the Division of Corporation Finance's Statements Regarding the Application of the Proxy Rules to Proxy Voting Advice" (Jun. 1, 2021), *available at* https://www.sec.gov/news/public-statement/peirce-roisman-response-statements-application-proxy-rules-060121#_ftn1.

[33] *See* SEC Release, *supra* note 40.

[34] Specifically, the rules granted an exemption for proxy advisors to the proxy solicitation rules, to the extent the proxy advisors: (1) prominently disclose material conflicts of interest to their clients along with any policies and procedures regarding how the firm addresses such conflicts and (2) have written policies and procedures reasonably designed to ensure that (i) companies that are the subject of the proxy advisors' voting advice have such advice made available to them at or prior to the time such advice is provided to proxy advisory clients, and (ii) proxy advisors' clients have a mechanism by which they can reasonably be expected to become aware of any written statements from those companies. *See* 17 C.F.R. § 240.14a-2(b)(9) (2021).

[35] *See* Chair Gary Gensler, "Statement on the application of the proxy rules to proxy voting advice" (Jun. 1, 2021), *available at* https://www.sec.gov/news/public-statement/gensler-proxy-2021-06-01.

[36] SEC Division of Corporation Finance, "Statement on Compliance with the Commission's 2019 Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice and Amended Rules 14a-1(1),

that repealed most of the protections in the 2020 rules (the "Redo Proposal").[37]

In July 2022, the SEC adopted the Redo Proposal,[38] though nothing had changed to justify repeal. In adopting the Redo Proposal, the SEC eliminated the regulatory certainty that companies rely on to plan and make key business decisions. During the proposal's brief comment period, many commenters were baffled by the resulting "regulatory whiplash."[39] By reversing the 2020 reforms before they went into effect, commentators noted that the SEC failed to provide serious evidence of new or changed circumstances to justify its actions. Commenters also criticized the Redo Proposal's cost-benefit analysis focused on benefits to proxy advisors' profitability, while ignoring the substantial costs to companies and investors. Moreover, it was impossible for the SEC to objectively judge the impact the 2020 reforms would have had in practice.

B. Prioritizing ESG Factors Over Financial Performance

One of the key concerns with proxy advisory firms is their inability to focus on the economic impact of shareholder proposals. By prioritizing social, environmental, and political issues over financial performance, these firms can undermine the fundamental purpose of the proxy voting system. This disregard for economic considerations can have detrimental consequences for retail investors, who rely on the financial success of the companies they invest in. Proxy advisors must be held accountable. They must provide recommendations that consider the long-term economic value of the company, not recommendations driven by non-economic factors or a one-size-fits-all approach.

Independent directors also play a crucial role in the decision-making of public companies. Independent directors bring expertise, objectivity, and a responsibility to act in the best interest of shareholders. Preserving the integrity of corporate governance requires giving deference to independent directors unless there is a clear justification to oppose their decisions. To achieve a fair and transparent corporate governance landscape that safeguards retail investors' interests, there must be a greater appreciation for the expertise of independent directors. Proxy advisors should be obligated to disclose their economic analysis and provide financial justifications when they recommend votes against the judgment of an independent board of directors. This disclosure empowers shareholders to make informed voting decisions based on an analysis of a company's economic value and long-term prospects, rather than relying solely on the social or political policy preferences of unaccountable proxy advisors.

C. Little Transparency or Accountability

14a-2(b), 14a-9" (Jun. 1, 2021), *available at* https://www.sec.gov/news/public-statement/corp-fin-proxy-rules-2021-06-01.

[37] *See* Proxy Voting Advice, Exchange Act Release No. 34-93595, 86 Fed. Reg. 67383 (Nov. 26, 2021), *available at* https://www.sec.gov/rules/proposed/2021/34-93595.pdf.

[38] *See* SEC Release, SEC Adopts Amendments to Proxy Rules Governing Proxy Voting Advice (Jul. 13, 2022), *available at* https://www.sec.gov/news/press-release/2022-120.

[39] *See* Commissioner Hester Peirce, U-Turn: Comments on Proxy Voting Advice (July 13, 2023), *available at* https://www.sec.gov/news/statement/peirce-statement-proxy-voting-advice-071322#_ftn7.

Proxy advisors operate without sufficient disclosure, making it challenging to assess the objectivity and reliability of their recommendations. This lack of transparency raises questions about potential biases and conflicts of interest that may influence the decision-making process. To address these issues, reforms are necessary to promote transparency and ensure accountability within the proxy advisory system.

For example, proxy advisors should publish annual reports that provide a comprehensive overview of their activities. This report should include a summary of the shareholder proposals reviewed, the recommendations made, and the financial analysis employed to justify those recommendations. By providing this information, proxy advisors can be held accountable for their actions and investors can make more informed decisions.

Additionally, the annual report should explicitly highlight instances where shareholder proponents are also clients of the proxy advisory firm. This disclosure is crucial in identifying potential conflicts of interest that may compromise the objectivity of the advisory firms. By highlighting these relationships, stakeholders can evaluate the impartiality of the proxy advisers and ensure that their recommendations are free from undue influence.

D. Inaccurate Information in Proxy Advisory Firm Reports

There are concerns about the detrimental impact of inaccurate information and incomplete analyses provided by proxy advisory firms. Investors who rely on the firms' recommendations are at risk of making uninformed decisions, undermining the integrity of the market. To address this issue, proxy advisors should engage in open and constructive communication with issuers, allowing issuers the opportunity to respond to and rectify any inaccuracies in the advisory reports.

To ensure accuracy and accountability, proxy advisory firms should also share draft reports with issuers before they are disseminated. This vital step allows companies to thoroughly review, identify any inaccuracies, and provide necessary corrections. This dialogue empowers issuers to present their perspective, ensuring that proxy advisory reports reflect a comprehensive and accurate understanding of the company's position.

Transparency is another key aspect that must be enhanced. Proxy advisory firms should disclose their methodologies, calculations, and sources of information. Doing so would provide issuers with the means to verify the accuracy of the data used in the reports. Transparent communication channels and disclosure promote a fair and reliable advisory process, fostering trust between issuers, investors, and proxy advisors.

3. Institutional Investors: The Role of Fiduciaries

The integrity of the investment market relies on the responsible and prudent actions of investment advisers, asset managers, and pension funds. These entities play a vital role in safeguarding the interests of shareholders by diligently executing their fiduciary duties. However, recent concerns have emerged regarding the undue influence of proxy advisory firms on voting decisions, potentially sidelining the economic interests of retail investors. The

following subsections will, therefore, examine, in greater detail, the role fiduciaries play to ensure that the interests of investors are protected and that voting decisions are aligned with the best economic interests of shareholders.

A. Examining Fiduciary Responsibilities

Investment advisers bear the ultimate responsibility for overseeing the proxy advisory firms they retain. The SEC's Staff Legal Bulletin No. 20 ("SLB 20") provides a starting point for this oversight. For example, SLB 20 states that investment advisers should "adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight … to ensure that [such advisers] … vote proxies in the best interests of [their] clients." [40]

Despite the SEC's position in SLB 20, it is necessary to examine whether investment advisers are genuinely fulfilling their fiduciary duties when relying on proxy advisory firms' recommendations. One particular concern arises when institutional investors blindly follow proxy advisory recommendations without conducting thorough evaluations of their own. For example, some firms engage in the practice of "robo-voting," where they automatically cast votes consistent with proxy advisor recommendations. This hasty approach not only undermines the quality of decision-making but also compromises companies' ability to present their case effectively.

While proxy advisory firms play a role in the proxy voting analysis, they should not have undue influence over voting decisions. Institutional investors must faithfully exercise their fiduciary duties by critically evaluating recommendations and ensuring they align with the best interests of their clients. As a result, institutional investors must engage in greater due diligence to avoid careless decision making and to protect the economic interests of the retail investors to whom their fiduciary duties are owed.

B. Inconsistent Proxy Voting Determinations

To enhance transparency and accountability, it is imperative that proxy advisory firm clients are required to publish detailed annual reports. These reports should encompass essential information, such as the percentage of votes cast in accordance with proxy advisory recommendations, the percentage of votes in favor of ESG-related shareholder proposals, and an explanation of how firms reconcile their votes with their fiduciary duty to act in the best economic interest of shareholders. By providing such comprehensive reporting, investors gain valuable insights into the decision-making processes of proxy advisory firm clients, enabling them to evaluate whether the firm is meeting its fiduciary obligations.

Similarly, large asset managers must demonstrate their commitment to accountability and transparency by publicly disclosing the economic analysis behind their shareholder voting decisions. The Working Group uncovered instances where the boards of several asset managers recommended that their shareholders vote against certain proposals during their annual meetings,

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[40] *See* Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms; Staff Legal Bulletin No. 20 (IM/CF) (Jun. 30, 2014).

while their investment arms voted in favor of the same proposals filed at other companies. By sharing the rationale behind their voting decisions, including the financial factors considered when opposing boards of independent directors, asset managers should justify these inconsistencies and empower shareholders to comprehend how economic interests are prioritized. This level of transparency fosters trust and enables investors to evaluate whether voting decisions align with their own financial objectives.

C. Empowering Investors

To enhance the alignment of voting decisions with retail investors' best interests, it is important to prioritize the expertise and independence of boards comprising independent directors. For example, when an investment adviser has authority to vote on a proxy in connection with a passively managed fund, they should defer to the recommendations of those boards on shareholder proposals related to social or political policy issues. By doing so, the integrity of those funds is maintained, ensuring that their focus remains on aligning voting decisions with the best interests of retail investors rather than pushing specific social or political preferences.

4. The Influence of Large Asset Managers

Three major asset managers, commonly referred to as the "Big Three," collectively manage approximately $20 trillion in assets. Their substantial holdings in America's largest companies, facilitated by the structure of index funds, grant them significant voting power and influence over corporate decisions. However, there are serious concerns about how these managers employ their voting power to advance political agendas that are unrelated to financial performance.

For example, many large asset managers as signatories to an international commitment to pursue net zero emissions by 2050.[41] This commitment requires, among other things, that asset managers prioritize emissions reductions within the sectors and companies in which they invest.[42] The promotion of a social or political agenda like this raises questions about transparency, accountability, and the impact on retail investors. Additionally, investors may be unaware of potential tradeoffs with these measures and financial performance.[43] Likewise, investors may not be aware that signatories to this commitment do not necessarily have better ESG scores or ESG-commitments.[44] As such, the following subsections explore the power of the Big Three and regulatory gaps that result in less transparency for retail investors who rely on the Big Three for their savings and retirement.

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[41] *See* THE NET ZERO ASSET MANAGERS INITIATIVE, *available at* https://www.netzeroassetmanagers.org/signatories/.
[42] *See* THE NET ZERO ASSET MANAGERS COMMITMENT, *available at* https://www.netzeroassetmanagers.org/media/2021/12/NZAM-Commitment.pdf.
[43] *See* Samuel M. Hartzmark & Abigail B. Sussman, Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows, THE J. OF FIN., VOL. LXXIV, No. 6 (Dec. 2019), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3016092.
[44] *Id.*

A. The Power of the Big Three

The Big Three's dominance in the index fund market grants them unparalleled influence. They have a combined voting share of approximately 25 percent at shareholder meetings of most S&P 500 companies.[45] Despite being labeled as passive investors, they actively utilize voting power to advance liberal social goals such as ESG and DEI (diversity, equity, and inclusion), which may not align with maximizing investor returns. This divergence raises concerns about the prioritization of political ideologies over the financial interests of retail investors. As discussed previously, Congress should consider policies that better align the voting behavior of passively managed index funds with retail investors' best interests.

Amid growing public concern, it is notable that one of the "Big Three" recognized the potential confusion the international net zero commitment presented for some investors.[46] In an effort to clarify its independence on investment decision, the entity withdrew from the Net Zero Asset Managers Initiative.[47]

B. Regulatory Gaps: Ownership and Control

Federal law requires large public company shareholders to publicly disclose their exercise of influence. However, the Big Three predominantly file abbreviated forms that lack relevant disclosures, leveraging an exception meant for passive investors. This lack of transparency hampers the investing public's understanding of the direction in which the Big Three push their portfolio companies. It also inhibits regulatory assessments of their policy implications.

Congress should consider reviewing the Big Three's compliance with existing disclosure requirements, with a specific focus on instances where abbreviated Schedule 13G short-form disclosures were filed. This review would help develop a more complete understanding of the extent to which the Big Three exercise influence over the management and corporate policy of their portfolio companies. Separately, defining "control" within securities laws is another crucial aspect that requires attention. This would enable a more accurate assessment of the Big Three's influence over banking organizations, triggering necessary regulatory restrictions and oversight to safeguard retail investors.

5. ESG Raters and their Impact on U.S. Public Companies

ESG rating agencies have garnered significant attention in recent years for their role in

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[45] *See* Lucian A. Bebchuk & Scott Hirst, The Specter of the Giant Three, 99 BOSTON UNIV. L. REV. 721, 736 (2019) ("the average share of the votes cast at S&P 500 companies at the end of 2017 was 8.7% for BlackRock, 11.1% for Vanguard, and 5.6% for SSGA. . . As a result, for S&P 500 companies, the proportion of the total votes that were cast by the Big Three was about 25.4% on average"). BlackRock recently began to permit certain clients to participate in proxy voting decisions, and Vanguard announced that it will launch a similar pilot program in early 2023.

[46] *See* Ross Kerber and Noor Zainab Hussain, *Vanguard quits net zero climate effort, citing need for independence*, REUTERS (Dec. 7, 2022), *available at* https://www.netzeroassetmanagers.org/media/2021/12/NZAM-Commitment.pdf.

[47] *Id*.

providing information about the ESG performance of companies. These ratings are used by investors, analysts, and corporate managers to guide their investment decisions. As noted earlier, there are serious concerns about the reliability and impact of ESG rating agencies, particularly on retail investors. As a result, the following subsections describe specific problems with ESG rating agencies, with a particular focus on their inconsistent methodologies and resulting negative impacts on our companies, investors, and our markets.

A. Lack of Standardization and Transparency

One of the major issues with ESG ratings is the inconsistent ratings assigned to the same company by different rating providers. Likewise, ratings appear inconsistent with the purported ESG benefits of the company in question, further calling the utility of ESG raters into question. For example, in May of 2023, Tesla, the world's largest maker of electronic cars, scored lower on S&P Global's ESG measures than Phillip Morris, the maker of cigarettes. [48] Tesla also scored lower than Chevron, the oil company demonstrating the arbitrary and somewhat subjective measure of any current ESG-related rankings.[49]

This lack of standardization stems from the divergent methodologies and data sources used by different raters. Consequently, it becomes exceedingly challenging to effectively compare and assess ESG ratings. Moreover, the lack of transparency in the ratings process further exacerbates the problem, leaving companies and investors in the dark about the basis for the assigned ratings. This raises serious doubts about the value and usefulness of ESG ratings.

Furthermore, ESG ratings have placed a substantial burden on U.S. companies and their retail investors. The proliferation of ESG rating providers forces companies to navigate and respond to a multitude of rating methodologies, leading to confusion and a waste of management time and resources. On the other hand, retail investors are left with unreliable and inconsistent ratings, making it arduous for them to make well-informed investment decisions.

Recent studies have highlighted the lack of consistency and standardization among ESG rating agencies. A 2020 study of institutional investors uncovers widespread concerns, including inaccuracy and inconsistency of data, inexperienced research analysts, and a perception that ESG quality cannot be distilled to a score.[50] This lack of reliability hampers investors' ability to accurately evaluate companies' ESG performance and poses a threat to the integrity of the investment landscape.

B. Negative Impact on U.S. Public Markets

There are significant concerns about the growing influence of ESG ratings on investment decisions. While ESG rating providers claim that their ratings can help mitigate investment risks and predict better returns, there is insufficient evidence to support these assertions. In fact, there is little correlation between ESG ratings and subsequent risk events or financial performance. In

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[48] *See* Al Root, *Tesla Got Added to an ESG Index. But Oil and Tobacco Firms Scored higher*., BARRON'S, June 1, 2023, *available at* https://www.barrons.com/articles/tesla-chevron-stock-sp500-esg-score-index-bf95e0fe.
[49] *Id*.
[50] *See* SustainAbility, "Rate the Raters 2020: Investor Survey and Interview Results," (Mar. 2020).

addition, as noted above, ESG ratings appear to be arbitrary and subjective. As a result, the widespread reliance on ESG ratings by institutional investors and the flow of funds into ESG-labeled investment products raise significant questions about the overall impact of these ratings on the market. If ESG ratings fail to accurately reflect a company's true ESG performance or financial risks, there is a considerable risk of capital misallocation and potential market distortions.

Recent studies and analyses have also cast doubt on the effectiveness of ESG ratings in predicting financial performance. For example, one study examined the relationship between fund sustainability and performance and found that funds with low sustainability ratings perform better than those with high ratings.[51] Another study assessed the performance of companies at the onset of the Covid-19 pandemic and found no evidence that ESG ratings predict performance during the unexpected risk event.[52] Moreover, an examination was conducted of ESG ratings outside of the U.S., primarily in European Countries, Australia, and Japan, and found that ESG scores of companies domiciled in these countries are not associated with risk-adjusted performance.[53] These findings highlight the need for the cautious interpretation and utilization of ESG ratings, as the potential misalignment between ratings and actual performance may have unintended consequences for investors and the broader market.

6. A Politicized SEC

Government agencies may act only when empowered to do so by Congress.[54] The federal securities laws limit the Commission's authority. Consequently, the SEC is not empowered to mandate disclosures or pursue rulemaking on any subject it deems important. Instead, unless otherwise explicitly authorized by Congress, the SEC's actions are confined to areas deemed necessary or appropriate to advance the objectives of the Acts.

The Supreme Court's June 2022 ruling in *West Virginia v. EPA* reaffirmed the position that a government agency's rulemaking authority is not unlimited.[55] In that case, the Court ruled that the major questions doctrine requires a government agency to point to clear congressional authorization to justify its actions. The Court also held that an agency cannot make up new interpretations of laws to justify far-reaching policy changes that Congress never intended.[56]

Under Chair Gensler's leadership and direction, the SEC has and continues to exceed its statutory authority and is testing the bounds of extreme agency overreach.[57] For instance,

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[51] *See* Samuel M. Hartzmark & Abigail B. Sussman, Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows, THE J. OF FIN., VOL. LXXIV, No. 6 (Dec. 2019), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3016092.

[52] *See* Elizabeth Demers, Jurian Hendrikse, Philip Joos, and Baruch Lev, *ESG Didn't Immunize Stocks During the COVID-19 Crisis, But Investments in Intangible Assets Did*, Journal of Business Finance & Accounting (2021).

[53] Florencio Lopez-de-Silanes, Joseph A. McCahery, and Paul C. Pudschedl, *ESG Performance and Disclosure: A Cross-Country Analysis*, Social Science Research Network (2019).

[54] *See Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 374 (1986).

[55] *See West Virginia v. EPA*, 597 U.S. 697 (2022).

[56] *Id*.

[57] *See* Letter to Gary Gensler, Chair, U.S. Securities and Exchange Commission, from Patrick McHenry et. al, Ranking Member, H. Comm. on Financial Services (Sept. 20, 2022), *available at* https://financialservices.house.gov/uploadedfiles/2022-09-

Congress has not granted the SEC the authority to create regulations that compel companies to disclose general information about ESG-related issues.[58] In fact, Congress has voiced its disapproval on the number and complexity of disclosures presently required by the SEC and has urged the agency to simplify them rather than adding to their complexity. Additionally, the SEC has previously stated that disclosures regarding environmental and social issues should only be mandated if required by law or if such information is deemed material to investors.[59]

The following subsections describe the politicization of the SEC in greater detail. For example, they discuss Chair Gensler's recent efforts to undermine the materiality standard and overstep the SEC's statutory authority by proposing and finalizing politicized ESG regulations such as the climate disclosure rule. In addition, the following subsections build on earlier sections to examine how Chair Gensler's efforts to overhaul the proxy process make it easier for activists to force private sector companies to take non-pecuniary measures, including purported ESG considerations, into account. Finally, the following subsections discuss other SEC-led efforts to promote ESG initiatives, including the SEC's development of a climate-related task force.

A. Undermining the Materiality Standard

The SEC's pursuit of ESG disclosure initiatives threatens to undermine the Commission's materiality standard. For decades, the materiality standard has been the touchstone of our public company disclosure regime. Under the federal securities laws, a company must disclose material information to prospective investors and shareholders so that they can make informed investment and proxy voting decisions.[60] With respect to ESG information, public companies are already required to make disclosures under current law when such information is considered material.

The SEC should be limited to imposing disclosure requirements that relate to material risk information. By maintaining a clear and stringent threshold for disclosure, the SEC will better protect investors by ensuring the companies they invest in disclose the information that is truly important for investment and proxy voting decisions. To help companies navigate other risks, such as climate-related risks that are not material to all public companies, the SEC should consider less onerous alternatives including the non-binding guidance promulgated by the SEC in 2010.[61]

20_final_mchenry_granger_comer_letter_to_sec_re_west_virginia_v._epa.pdf. *See also* Letter to Megan Barbero, General Counsel, U.S. Securities and Exchange Commission, from Bill Huizenga and Ann Wagner (Apr. 17, 2023) (on file with Committee).

[58] *See* The Enhancement and Standardization of Climate-Related Disclosure for Investors, 17 CFR 210, 229, 232, and 249.

[59] *See* SEC, Concept Release, Business and Financial Disclosure Required by Regulation S-K, *available at* https://www.sec.gov/files/litigation/litreleases/2016/33-10064.pdf.

[60] 17 CFR § 230.405.

[61] In 2010, the SEC provided non-binding guidance for disclosing climate-related risks. Under the 2010 guidance, the SEC explained where and how companies may use the existing securities laws to disclose climate-related risks. For examples, the 2010 Guidance covered disclosures in the description of business (Item 101), legal proceedings (Item 103), risk factors (Item 105), and management's discussion and analysis of financial condition and results of operations (Item 303). *See*, Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106, 34-61469, available at 75 Fed. Reg. 6,290 (Feb. 8, 2010).

B. Climate Risk Disclosures

On March 21, 2022, the SEC proposed a 490-page rule entitled, *The Enhancement and Standardization of Climate-Related Disclosure for Investors* (the "Climate Disclosure Rule") to replace voluntary sustainability reports with mandatory disclosures that include detailed emissions data and climate risk management strategies.[62] Two years later, on March 6, 2024, the SEC adopted an almost 900-page final version of the Climate Disclosure Rule.[63] Although some of the most egregious aspects of the proposed rule were curtailed, the final rule includes far-reaching effects that have little to do with material financial risks.

For example, while the final rule scrapped certain overly granular measures such as the proposed requirements to disclose whether directors have expertise in climate-related risks, it does mandate a one-size fits all disclosure requirement pertaining to oversight of the board of directors and management of climate-related risks. Additionally, the final rule still seeks to elicit disclosures about a board's oversight of climate-related matters, including, but not limited to, whether and how the board of directors oversees progress against disclosed climate-related targets, goals, or transition plans.[64] By including requirements like these, the SEC assumes companies and their boards should place more emphasis on climate-related risks (including, in certain cases, those that are admittedly not material) than on other risks which may be more financially important to the company.

Perhaps more notably, the final rule removed the requirement that all public companies disclose their Scope 3 greenhouse gas emissions, which are often impossible to compile and would indirectly impose regulatory burdens on companies the SEC has no jurisdiction over.[65] However, there is no provision in the final rule allowing companies to exclude targets or goals framed in terms of Scope 3 greenhouse gas emissions. Thus, companies may need to report progress toward a climate-related goal, such as a net zero goal, that includes Scope 3 greenhouse gas emissions reductions. As a result, they must also make, and be responsible for the collection and accuracy of, some level of disclosure of the Scope 3 greenhouse gas emissions themselves.

Despite scaling back certain aspects of the proposed rule, the Climate Disclosure Rule remains an onerous, costly, and ineffective means to dictate climate policy. Put simply, the SEC is not the correct agency to advance the administration's progressive climate-related policy goals. The Committee on Financial Services held a hearing on April 10, 2024, to listen to expert

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[62] *See* SEC Press Release "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors" (Mar. 21, 2022), available at https://www.sec.gov/news/press-release/2022-46.

[63] *See* SEC Adopting Release, "The Enhancement and Standardization of Climate-Related Disclosures for Investors" (March 6, 2024), *available at*: https://www.sec.gov/rules/2022/03/enhancement-and-standardization-climate-related-disclosures-investors#33-11275.

[64] Transition plans include strategy and implementation plans to reduce climate-related risks, which may include plans to reduce GHG emissions in line with the company's own commitments or commitments of jurisdictions within which it has significant operations. Notably, disclosure regarding transition plans turns on the materiality of the transition risk to which the transition plan relates, not the materiality of the transition plan itself, meaning companies may need to disclose an immaterial transition plan in response to a material transition risk.

[65] Scope 3 greenhouse gas emissions include indirect sources of greenhouse gases from the company's operations. For instance, if a company's employees drive to work, the gasoline they burn falls under Scope 3 emissions.

testimony from a range of experts, including the former Acting Chairman of the SEC, Elad Roisman to deal with the complexities of complying with the new rule.[66]

In their testimony, witnesses detailed the practical challenges companies must face to quickly achieve compliance with a rule that, by the SEC's own estimates, would increase the costs associated with being a public company by at least 21 percent.[67] For example, to comply with requirements to include the unknown and perhaps unquantifiable impacts of "severe weather events" and "other natural conditions" in the footnotes to the financial statements, companies will be forced to overhaul their existing accounting software, spending significant resources to develop systems (in combination with internal and external accountants and other consultants) that capture expenditures and costs that are difficult to identify. They must also use their judgment to disclose—or face litigation for their failure to adequately disclose—information related to ambiguous terms, such as "severe weather events" and "other natural conditions," which were left undefined.

Since the publication of the Preliminary Report, the Working Group's position has not changed. Namely, the SEC should not have finalized any version of the Climate Disclosure Rule. The SEC does not have the legal authority to enforce climate-focused regulations, and the rule compromises the traditional concept of materiality.[68] As discussed in more detail below, the SEC's proposal could also be in violation of the First Amendment, the major questions doctrine, and will discourage companies from entering or remaining in the public markets.[69]

This viewpoint has been expressed by a range of stakeholders across the political and ideological spectrum. Increasingly, while we are hesitant to make any predictions, certain federal courts appear to be receptive to constitutional arguments against the Climate Disclosure Rule that is undergoing a challenge in the Eighth Circuit. The SEC's unusual step of freezing the rule on its own on April 4, 2024, as the Eighth Circuit undertakes a rule of the merits, suggests the SEC has at least some doubts on the eventual outcome of the matter. [70]

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[66] Beyond Scope: How the SEC's Climate Rule Threatens American Markets: Hearing Before the H. Comm. on Financial Services, 118th Cong. (2024).

[67] The SEC's estimates are likely too low because they exclude, for example, the considerable costs companies must incur to make "materiality" determinations when deciding whether certain disclosures are necessary. *See* SEC Adopting Release, "The Enhancement and Standardization of Climate-Related Disclosures for Investors" (March 6, 2024), *available at*: https://www.sec.gov/rules/2022/03/enhancement-and-standardization-climate-related-disclosures-investors#33-11275; *see, also*, Statement of Commissioner Hester M. Peirce, Green Regs and Spam: Statement on the Enhancement and Standardization of Climate-Related Disclosures for Investors (Mar. 6, 2024), available at: https://www.sec.gov/news/statement/peirce-statement-mandatory-climate-risk-disclosures-030624.

[68] The rule risks overwhelming investors with irrelevant information and causing confusion about the certainty of disclosures and new metrics. The extensive and detailed nature of these requirements will also place a disproportionate emphasis on climate risk and make it harder for investors to identify material information about other matters contained in annual reports and registration statements.

[69] Millions in compliance costs, plus the intricacies of new climate reporting systems, will divert management attention and require public companies to divert significant corporate resources. Private companies may consider this and decide to stay away from public markets, reducing the opportunity for retail investors to engage in public value creation.

[70] *Chamber of Com. of the USA v. SEC*, No. 23-60255, at *4 (5th Cir. Dec. 19, 2023); After arguing against the Fifth Circuit's decision to stay the rule, the SEC voluntarily took that step on its own before the Eighth Circuit on April 4, 2024. *See In re Enhancement and Standardization of Climate-Related Disclosures for Investors*, Rel. Nos. 33-11280, 34-99908 (Apr. 4, 2024) (announcing a voluntary stay of the rule).

C. **Human Capital Management Disclosure**

In 2020, the SEC sought to improve investor access to human capital information by implementing a rule that requires companies to disclose their human capital management measures and objectives. However, this rule only applies if those measures or policies are deemed material to the company's business as a whole.[71] The SEC acknowledged that human capital management disclosures vary across industries and therefore, adopted a principles-based approach to this topic. This approach provides flexibility for companies to customize their disclosure according to their specific needs.

According to its Spring 2024 Regulatory Flexibility Agenda, the SEC is continuing with its plans to propose a new rule that would introduce additional qualitative and quantitative disclosures related to workforce management.[72] Unlike prior chairs' principles-based approaches to rules, the new rule would prescribe specific data points to be disclosed, which may or may not be material to every company. These rules will increase the costs associated with public company disclosures, making securities activities more expensive, burdening the capital formation process, and ultimately discouraging private companies from going public.

As of the date of this memorandum, we are not aware of a specific timetable for this proposal. It is possible, given the SEC's numerous recent defeats in Court on both certain rulemaking and the use of administrative courts, that the SEC has decided not to move forward with this rulemaking. Moreover, given that that a proposal has not moved forward despite having appeared in prior versions of the SEC's Regulatory Flexibility Agendas,[73] the SEC may delay the adoption of this proposal until there is a more politically and judicially receptive environment to do so.

D. SEC Rule 14a-8 No-Action Letter Process

Exploiting the shareholder proposal process for social, environmental, and political ultimately undermines shareholder value for retail investors. The recent surge in ESG-related proposals adds unnecessary pressure on corporate boards, wastes corporate resources, and hinders informed decision-making by retail investors, who must spend valuable time reading and evaluating these proposals.

The SEC's ambiguous 14a-8 process continues to fuel the influx of ESG-related proposals, further burdening companies. As previously mentioned, publicly traded companies are experiencing an unprecedented wave of shareholder proposals focused on environmental and social issues. This surge is a direct result of the SEC's decision to eliminate the requirement

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[71] *See* SEC, Final Rule, "Modernization of Regulation S-K Items 101, 103, and 105" (Aug. 26, 2020) available at https://www.sec.gov/news/press-release/2020-192.

[72] *See* Office of Information and Regulatory Affairs Spring 2024 Unified Agenda of Regulatory and Deregulatory Actions (Jul. 8, 2024), *available at* https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202404&RIN=3235-AM88.

[73] *See*, *e.g.*, Office of Information and Regulatory Affairs Fall 2022 Unified Agenda of Regulatory and Deregulatory Actions (Jan. 4, 2023), *available at* https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202210&RIN=3235-AM88.

necessitating proposals relevancy to a company's business, as well its decision to implement Staff Legal Bulletin 14L. In addition, the SEC is proposing amendments to Rule 14a-8 that will only serve to encourage more activism, placing additional strain on companies' and investors' time and resources.

There must be sensible reforms to the SEC's no-action letter process such as granting companies greater autonomy in developing their own shareholder proposal procedures. More broadly, decision-making should remain in the hands of the company and its shareholders, not activist stakeholders. Additional reforms aimed at improving corporate governance for the benefit of companies and their shareholders are discussed in more detail below.

E. Other ESG-Related Initiatives

In addition to its proposed Climate Disclosure Rule, the SEC has focused on other ESG-related endeavors and unnecessary rulemaking to promote or at least "nudge" in the direction of certain outcomes. These endeavors include, but are not limited to, launching an SEC task force focused on climate and ESG issues and announcing an "enhanced focus" on climate-related risks in the SEC's examinations work.[74] Rather than suddenly viewing itself as a climate change regulator and ESG proponent, the SEC should return to focusing on its clear statutory mission.

7. The Extraterritorial Impact of EU Disclosure Regulations on U.S. Public Companies

American businesses and their investors are, unfortunately, not just burdened by ESG-related initiatives in the United States. Instead, recent climate-related directives by the EU include far-reaching impacts that will negatively affect U.S.-based companies and, in turn, their investors. For example, on January 5, 2023, the EU's implemented Corporate Sustainability Reporting Directive ("CSRD").[75] Subsequently, on May 24, 2024, the EU approved a scaled back version of the Corporate Sustainability Due Diligence Directive ("CS3D") proposal.[76] As discussed in more detail below, these directives have the potential to harm both the companies and their retail investors. Moreover, the Biden Administration has exacerbated the burdens and made it harder for U.S. companies to compete globally by failing to represent U.S. interests and negotiate an equivalence agreement with the EU.

A. The Burdensome Effects on U.S. Companies

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[74] *See* SEC Press Release, "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues" (Mar. 4, 2021), available at https://www.sec.gov/news/press-release/2021-42; SEC press release: SEC Division of Examinations Announces 2021 Examination Priorities (Mar. 3, 2021), *available at* https://www.sec.gov/news/press-release/2021-39.
[75] *See* EU Website, Corporate sustainability reporting, *available at* https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en
[76] *See* Patrick Spath, Jakob Tybus, Tim Bartels, Morrison Foerster Client Alert, *What you should know about the CS3D and Forced Labor Regulation and Their Impact on Your Business Activities*, *available at* https://www.mofo.com/resources/insights/240620-what-you-should-know-cs3d-forced-labor-regulation#_ftn-ref1.

The EU's application of CSRD to U.S. companies operating outside the EU represents a departure from established precedent, subjecting a vast number of U.S. firms to the regulation. With a low threshold of $150 million, nearly 65 percent of companies listed in the S&P 500, as well as smaller and medium-sized businesses, are captured. These companies are now required to disclose their Scope 3 greenhouse gas emissions, as mandated by the EU. This forces U.S. companies to comply with costly regulations imposed by a foreign regulator. Moreover, the burden extends to clients of these U.S. companies, affecting the U.S. economy more broadly.

CS3D poses even greater concerns than CSRD. This directive would capture a higher number of U.S.-based companies, particularly those in "high-impact sectors", including, but not limited to, textiles, agriculture, fuels, and chemicals. Companies operating within these industries would be subject to the rule if their EU revenues reach a threshold of €450 million among other factors. CS3D not only requires disclosure but also mandates the identification, mitigation, and resolution of adverse environmental and social impacts as well as requires U.S. companies to implement a Paris-aligned climate transition plan. This places U.S. companies in a position where they must force their U.S.-based suppliers and customers to reduce greenhouse gas emissions, irrespective of the economic consequences.

B. The Failure of the Biden Administration to Defend U.S. Interests

During a U.S.-EU Joint Regulatory Forum, representatives from various U.S. departments and agencies engaged in discussions on sustainable finance, including the topic of sustainability-related financial disclosures. The joint press release indicated support and awareness of these EU initiatives from U.S. officials. This collaboration raises concerns that U.S. regulators are circumventing U.S. sovereignty by working with international counterparts to impose rules in the U.S., potentially undermining U.S. interests.

The U.S. Department of Treasury historically defended American interests from the extraterritorial reach of foreign regulators. However, given that the CSRD and CS3D rulemakings represent an unprecedented intrusion into the U.S. economy, the subsequent lack of action by the Biden Administration to prevent or negotiate an equivalent agreement undermines the protection of U.S. companies and their operations.

8. State Regulations

States regulators are also beginning to force companies to comply with onerous climate-related financial regulations. California, due to its strong politically liberal leanings, went further than the SEC's Climate Disclosure Rule by passing an even more ambitious and job-killing environmental agenda in the form of three climate disclosure bills on October 7, 2023.

- Assembly Bill 1305, also known as the "Voluntary Carbon Market Disclosure Act," requires specific disclosure for business entities on the marketing or selling of carbon offsets;[77]

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[77] Cal. Assembly Bill 1305, *the Voluntary Carbon Market Disclosure Act*, *available at* Bill Text - AB-1305 Voluntary carbon market disclosures.

- Senate Bill (SB) 253, also known as the "Climate Corporate Data Accountability Act" requires mandatory climate disclosures;[78] and
- Senate Bill (SB) 261, also known as the "Greenhouse Gases: Climate-related Financial Risk Act," mandates disclosure of climate-related financial risk in accordance with the recommendations of the Task Force on Climate-related Financial Disclosures ("TCFD").[79] The TCFD is not a balanced approach on how to deal with such a problem and is not reflective of the preferences of most Americans but does appear to create a lucrative market for activists in this space.

The three bills, which are much more expansive in scope than the SEC's Climate Disclosure Rule, apply to both private and public companies. Moreover, unlike the Climate Disclosure Rule, Senate Bill 253 requires the disclosure of Scope 3 greenhouse gas emissions, which are emissions that result from the activities from assets not owned or controlled by the business but that the business indirectly affects in its value chain. Similar, to the SEC's Climate Disclosure Rule, there is active litigation against these bills as they demonstrate bureaucratic overreach, actively harm investors and businesses, and have little-to-no impact on environmental factors. [80] Notably, in July 2024, California Governor Newsom's administration proposed amendments that would delay implementation of SB 253 and SB 261 until 2028.[81]

V. THE WAY FORWARD: CONGRESS AND THE COURTS

Consistent with its mission, the Working Group identified several pathways to combat ESG initiatives that harm American businesses and their investors. For example, the courts have played a crucial role in reminding regulators that their power is not unchecked. Likewise, the House Committee on Financial Services has developed legislation to ensure guardrails are in place to increase transparency, reduce ambiguity, and protect investors from certain ESG initiatives. The Committee has also taken its oversight role seriously, engaging in document requests and other measures to hold regulators accountable. The following sections discuss each pathway in greater detail.

1. The Courts

The courts have been instrumental in ongoing efforts to reign in aggressive regulatory overreach. For example, in *Loper Bright Enterprises v. Raimondo*, the Supreme Court appears to have limited agency rulemaking to some degree.[82] There is also ongoing litigation challenging certain actions related to the proxy process, and state and federal climate-related disclosure rules.

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[78] Cal. SB 253, *the Climate Corporate Data Accountability Act*, *available at* https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202320240SB253.
[79] Cal. SB 261, *the Greenhouse Gases: Climate-related Financial Risk Act*, *available at* https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240SB261.
[80] *See Chamber of Com. Of the U.S. et al. v. Calif. Air. Res. Bd. et al.,* No. 2:24-cv-00801 (C.D. Cal. 2024).
[81] Proposed amend. to Cal. SB 253 and Cal. SB 261, is available at https://esd.dof.ca.gov/trailer-bill/public/trailerBill/pdf/1148; *see also* Jon McGowan*, California Moves To Delay Corporate Climate Reporting Requirement Until 2028,* Forbes (Jul. 15, 2024), *available at* https://www.forbes.com/sites/jonmcgowan/2024/07/15/california-moves-to-delay-corporate-climate-reporting-requirement-until-2028/.
[82] *See Loper Bright Enters. v. Raimondo*, No. 22-4751, 2024 WL 3208360, at * 35 (U.S. June 28, 2024).

The following subsections discuss the role of the courts in more detail.

A. The United States Supreme Court: Limitations on Agency Rulemaking

In *Chevron U.S.A., Inc. v. NRDC*, the Supreme Court established a two-part test requiring courts to defer to government agencies when interpreting ambiguous statutes.[83] This standard (known as "Chevron deference") faced deep criticism for granting excessive power to unelected bureaucrats, leading to an ever-expanding administrative state and removing judicial interpretations from the courts. In fact, the decision in Chevron was so controversial, and in Chief Justice Roberts' view "unworkable," that it had not been relied on in over ten years.[84]

In June of 2024, the Court reversed its decision in Chevron by a 6-3 vote in *Loper Bright Enterprises v. Raimondo*. In that case, Chief Justice Roberts noted that, "courts need not and under the APA [the Administrative Procedure Act] may not defer to an agency interpretation of the law simply because a statute is ambiguous."[85] He added that, "it thus remains the responsibility of the court to decide whether the law means what the agency says."[86] In his opinion, Roberts correctly rejected the notion that agencies are better suited than courts to resolve ambiguities in Congressional statutes.[87]

While the exact effects of this decision are currently difficult to quantify, it appears that it will limit SEC agency rulemaking to some degree in the future. The decision may also allow for legal challenges to previous rulemaking that relied on Chevron deference, notwithstanding Roberts' admonition the decision in *Loper* would not apply retrospectively. Importantly, however, the decision serves as a much-needed reminder that agencies' authority is neither unlimited nor unchecked.

B. The National Association of Manufacturers: Challenging SEC Proxy Process Fouls

The National Association of Manufacturers ("NAM") is the nation's largest manufacturing industrial trade association, representing 14,000 small and large manufacturing companies in every industrial sector. Due to concerns over the influence of proxy advisory firms, NAM has recently been involved in two separate but related actions in federal court.

In one case, NAM challenged Chair Gensler's unprecedented, politically motivated decision to reverse his predecessor's rules bringing transparency to proxy advisory firms. Namely, NAM argued that the SEC's decision to rescind the rule shortly after it was finalized violated the APA.[88] It stated that, the "SEC does not—no doubt because it cannot—offer any compelling justification for why the exact same factual record requires a different result this time around."[89] In an opinion issued in June 2024, the Fifth Circuit sided with NAM, finding that the

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[83] *See Chevron U.S.A., Inc. v. NRDC*, 467 U.S. 837, 842-843 (1984).
[84] *Roberts, J.*, Oral Argument, *Loper Bright Enterprises*, 2024 WL 3208360.
[85] *Loper Bright Enterprises*, 2024 WL 3208360 at * 35.
[86] *Id.* at *15 *citing* "remains the responsibility of the court to decide whether the law means what the agency says." *Perez v. Mortgage Bankers Assn.*, 575 U. S. 92, 109 (2015) (Scalia, J., concurring in judgment).
[87] *Id.* at *22.
[88] Compl., *Nat'l Ass'n of Mfrs. v. SEC,* No. 7:22-CV-00163 at * 4-5 (W.D. Tex. July 21, 2022).
[89] *Id.* at 5.

SEC acted "arbitrarily and capriciously" when it voided the notice-and-awareness provisions of the 2020 rule. These provisions would increase engagement between proxy advisory firms and public companies, requiring proxy advisory firms to provide their recommendations to companies and make investors aware of any company responses to the recommendations.[90]

Following the Fifth Circuit's decision, the notice-and-awareness provisions of the 2020 rule would usually take effect as originally intended. However, in a separate suit initiated by proxy advisory firm ISS, the DC District Court held in a February 2024 opinion that the 2020 SEC amendments were "contrary to law and in excess of statutory authority" and should not take effect.[91] Both NAM and the SEC have filed an appeal in the DC Circuit as a result. If the DC Circuit agrees that the SEC has the authority to regulate proxy voting advice, then the 2020 rule's notice-and-awareness provisions would finally take effect. A victory in this case would ensure progress is made in ongoing efforts to increase transparency and accountability for proxy advisory firms.

C. ExxonMobil: Challenging Bad Faith Activists

In January of 2024, ExxonMobil ("Exxon") filed a federal lawsuit in the Northern District of Texas to block an activist shareholder proposal by Follow This and Arjuna Capital.[92] Exxon challenged the proposal, which sought to force significant cuts to the company's greenhouse gas emissions, arguing it would "force [it] to change the nature of its ordinary business or to go out of business entirely."[93] In response, Arjuna Capital agreed to withdrawal its proposal and to have the case dismissed, reluctantly agreeing not to submit any similar proposals in the future.

This marked the first prominent legal pushback against this type of activism, suggesting companies might prefer relying on the courts than seeking no-action relief from a politicized SEC. As Exxon noted in its filing, the proposal "does not seek to improve ExxonMobil's economic performance or create shareholder value."[94] After its victory, Exxon's chief executive issued stated that the "lawsuit put a spotlight on the widespread abuse of the shareholder proxy submission process."[95] He added that, "[m]aking repeated proposals that garner a small minority of support doesn't serve anyone's interest except the proponent's."[96]

This case highlighted an egregious example of shareholder activism, where the proposal was specifically designed to harm the company and its shareholders. However, the actions taken by the California Public Employees' Retirement System ("CalPERS") and proxy advisory firm

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[90] *Nat'l Ass'n of Mfrs. v. SEC*, No. 22-51069, 2024 WL 3175755, at * 10 (5th Cir. June 26, 2024).
[91] Cydney Posner, *SEC and NAM appeal decision holding 2020 proxy advisor rule amendments unlawful*, Apr. 29, 2024, *available at* https://cooleypubco.com/2024/04/29/sec-nam-appeal-2020-proxy-advisor/.
[92] *See Exxon Mobil Corp. v. Arjuna Capital, LLC et al.,* No. 4:24-cv-00069-P (N.D. Tex. June 17, 2024)
[93] Compl., Arjuna Capital, LLC et al., at * 4.
[94] See Id. at * 2 (Exxon cites to defendant's own website, which states: "We buy shares in order to work on our mission to stop climate change, **not to make a financial profit**." (Emphasis added); *see also* Sydney Ember, *Exxon Suit Over Activist Investor's Climate Proposal Is Dismissed: A federal judge ruled that the case was moot after the investor, Arjuna Capital, withdrew the proposal with a promise not to try again*., N.Y. TIMES, June 17, 2024, *available at* https://www.nytimes.com/2024/06/17/business/exxon-arjuna-lawsuit-dismissed.html.
[95] Message from Darren Woods, ExxonMobil, Chairman and CEO, June 18, 2024, *available at* https://corporate.exxonmobil.com/news/corporate-news/message-from-the-chairman.
[96] *Id*.

Glass Lewis reveal a troubling trend. CalPERS, which owned an estimated $1.1 billion of Exxon stock as of December 2023, retaliated by voting against all of Exxon's directors at its next shareholder meeting.[97] Similarly, Glass Lewis recommended voting against Exxon's lead independent director Joseph Hooley's re-election, citing "unusual and aggressive tactics" against activist investors.[98]

These actions signal that some institutions are so focused on pushing political and social objectives on companies that they will punish those that exercise their legal right to challenge improper shareholder proposals. Voting against board members for seeking legal recourse is extreme and undermines the welfare of the company and the economic interests of other shareholders. Such behavior is also undemocratic and un-American, as it punishes institutions for seeking justice through the legal system. This underscores the urgent need for reform in the proxy process, including addressing SEC positions that facilitate activism and create ambiguities in the no-action letter process.

D. The Climate-Related Disclosure Rules: Plagued with Legal Challenges

Numerous lawsuits challenging the SEC's Climate Disclosure Rule were filed shortly after its adoption, including from companies, industry representatives, and attorneys general from over a dozen Republican-led states.[99] On March 15, 2024, the Fifth Circuit Court of Appeals granted a request for an administrative stay.[100] The stay was later lifted, and following the SEC's request to consolidate at least nine of the pending lawsuits, the Eighth Circuit Court of Appeals was randomly selected via a lottery to consider the rule's legal challenges.[101] On April 4, 2024, the SEC decided to voluntarily stay the rule pending judicial review.[102]

Despite its voluntary stay of the rule, the SEC vowed that it plans to "vigorously defend" the Climate Disclosure Rule in court.[103] To survive, the rule must overcome substantial legal challenges including those set forth below. In addition, the Supreme Court's recent decision to

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[97] *See* Ross Kerber, *CalSTRS joins campaign against top Exxon directors*, REUTERS, May 23, 2024, *available at* https://www.reuters.com/sustainability/boards-policy-regulation/calstrs-votes-against-exxons-woods-hooley-2024-05-23; *see* WSJ Editorial Board, *The Exxon Directors and the Proxy Abusers: Progressives retaliate after the company fights back against a shareholder resolution that would harm other investors*, WALL ST. J , May 21, 2024, *available at* https://www.wsj.com/articles/exxon-mobil-proxy-voting-shareholder-resolution-arjuna-capital-follow-this-afe881fa.

[98] *Id*.

[99] *See*, *e.g*., Clark Mindock, Challenges to SEC's climate rules sent to conservative-leaning US appeals court, Reuters (Mar. 22, 2024), available at: https://www.reuters.com/legal/challenges-secs-climate-rules-sent-conservative-leaning-us-appeals-court-2024-03-21/.

[100] Perry Cleveland-Peck and Dylan Tokar, U.S. Appeals Court Temporarily Halts SEC Climate-Disclosure Rule, Wall Street Journal (Mar. 18, 2024), available at: https://www.wsj.com/articles/u-s-appeals-court-temporarily-halts-sec-climate-disclosure-rules-456f2f4c.

[101] *See*, e.g., Clark Mindock, Challenges to SEC's climate rules sent to conservative-leaning US appeals court, Reuters (Mar. 22, 2024), available at: https://www.reuters.com/legal/challenges-secs-climate-rules-sent-conservative-leaning-us-appeals-court-2024-03-21/; Andrew Levine, Ulysses Smith and Isabelle Glimcher, The Challenges SEC's Climate Disclosure Rule May Face, Law360 (Mar. 19, 2024), available at: https://www.law360.com/articles/1814872.

[102] *See In re Enhancement and Standardization of Climate-Related Disclosures for Investors*, Rel. Nos. 33-11280, 34-99908 (Apr. 4, 2024) (announcing voluntary stay).

[103] *Id*.

overturn Chevron could lead courts to scrutinize the SEC's actions with respect to the Climate Disclosure Rule more closely.

- The Major Questions Doctrine: The SEC violated the major questions doctrine, as articulated by the Supreme Court in *West Virginia v. EPA*, by finalizing climate-related regulations, which are outside of its purview, without clear direction from Congress.

- Statutory Authority: The SEC's rulemaking authority is limited by Section 13(a) of the Exchange Act, which only allows the SEC to require disclosures that are "necessary or appropriate for the proper protection of investors and to ensure fair dealing in the security."[104] Without specific direction from Congress to mandate the types of disclosures required by the Climate Disclosure Rule, the SEC exceeded its statutory authority.

- First Amendment: The climate-related disclosures required by the rule are not "purely factual and uncontroversial" and may be considered "compelled speech" in violation of the First Amendment.[105]

- The Administrative Procedure Act: There are several arguments suggesting the SEC violated the safeguards set forth by the APA, including (among others) the following:

    - The rule is arbitrary and capricious because the SEC failed to take public comments sufficiently into account, justify the rule's purported benefits, or conduct an adequate cost-benefit analysis.
    - The SEC also failed to consider less restrictive alternatives. The rule has substantially changed relative to the proposed rule (i.e., by removing mandatory Scope 3 GHG emissions disclosures, among other things), and the SEC did not allow the public adequate notice and opportunity to comment.
    - The SEC failed to explain its deviation from precedent by requiring extensive disclosures of non-material climate-related risks.

California's state-level climate disclosure rules are also being challenged in court. On January 30, 2024, the U.S. Chamber of Commerce, the California Chamber of Commerce, American Farm Bureau Federation, Los Angeles County Federation, Central Valley Business Federation, and Western Growers Association filed suit against California Resources Board in the Central District of California, Western Division over SBs 253 and 261.[106] Given this is a state-based lawsuit, there are unique aspects to this legal challenge apart from some of the

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[104] 15 U.S.C. § 78m(a).

[105] Specifically, the rule presents First Amendment issues by compelling issuers to disclose non-factual information that is subject to controversy in SEC filings. The Supreme Court uses strict scrutiny when assessing regulations that restrict free speech. *See Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*, 471 U.S. 626 (1985). While climate change and its impact on capital markets remain a major topic of debate, the proposal's compelled disclosure of non-material and non-ascertainable information in audited financial statements violates the First Amendment. The proposed Item 1503 of Regulation S-K involves subjective assessments of short-, mid-, and long-term risks that cannot be verified. Board-level expertise on climate risk assessment is also subjective and potentially controversial. Issuers should not be forced to provide information that may mislead stakeholders under highly prescriptive disclosure mandates.

[106] *See Chamber of Com. Of the U.S. et al. v. Calif. Air. Res. Bd. et al.*, No. 2:24-cv-00801 (C.D. Cal. 2024).

lawsuits against the SEC. However, similar to the Climate Disclosure Rule, the plaintiffs challenging the rule allege First Amendment concerns.[107] These cases, at both the state and federal levels, demonstrate, in part, why climate-related disclosure rules are especially problematic and should not have been finalized in the first place.

2. Targeted Legislative Action

To address the serious and ongoing threats identified in this Final Report, the Working Group has identified a series of legislative solutions that are consistent with the key priorities laid out in Part II. Each of these legislative steps are discussed in more detail below.

A. H.R. 4767: The Protecting Americans' Retirement Savings from Politics Act

Introduced on July 20, 2023, by Representative Bryan Steil, H.R. 4767 would enact measures aimed at preserving the integrity of the proxy voting process by reducing the impact of political activists, proxy advisory firms, and the SEC in introducing political elements into proxy voting.[108] H.R. 4767 is a compilation of 11 previously introduced bills that, among other things, reform the proxy process and increase transparency over proxy advisory firms. Examples of the policies included in the *Protecting Americans' Retirement Savings from Politics Act* are set forth below.

- Title I – H.R. 4641, the *Performance Over Politics Act,* was introduced on July 14, 2023, by Representative Scott Fitzgerald. It adjusts the thresholds to exclude repeat submissions under Rule 14a-8(i)(12) to 10 percent, 20 percent, and 40 percent, respectively. These adjustments strike a balance between encouraging shareholder engagement and fostering a more efficient and focused decision-making process. They are especially necessary, given that proxy advisory firms can easily garner enough support for unpopular, non-material environmental and social policies to exceed existing resubmission thresholds. When management discussions are inundated with numerous immaterial, unpopular repeat proposals encouraged by proxy advisors, it detracts from addressing economically significant matters immaterial like research, development, and corporate strategy.

- Title II – H.R. 4644, the *No Expensive, Stifling Governance Act*, was introduced on July 14, 2023, by Representative Erin Houchin. It prevents the SEC from finalizing or implementing the positions contained in a proposed rule called "Substantial Implementation, Duplication, and Resubmission of Shareholder Proposals under Exchange Act Rule 14a-8" (87 Fed. Reg. 45052). That proposed rule would benefit ideological activists, while harming companies and their long-term investors, by making it more difficult for companies to exclude shareholder proposals that have already been substantially implemented, are duplicative of other proposals on a given year's proxy ballot or have been rejected by a large percentage of shareholders in previous years.

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[107] Harvard Law School Environmental & Energy Law Program, Abby Husselbee & Sara Dewey, Litigation Updates on California's New Climate Disclosure Laws, *available at* https://eelp.law.harvard.edu/2024/02/litigation-updates-on-californias-new-climate-disclosure-laws/.
[108] *See* H.R. 4767, *Protecting Americans' Retirement Savings from Politics Act*, *available at* https://docs.house.gov/meetings/BA/BA00/20230727/116295/BILLS-118HR4767ih.pdf.

- Title IV – H.R. 4657, *a bill to clarify that an issuer may exclude a shareholder proposal pursuant to section 240.14a-8(i) of title 17, Code of Federal Regulations, without regard to whether such proposal relates to a significant social policy issue*, was introduced on July 14, 2023, by Representative John Rose. It clarifies that Rule 14a-8 exclusions permit a company to exclude a shareholder proposal from their proxy ballot regardless of whether the SEC deems an issue a "significant policy" matter. In doing so, it overturns the detrimental policy in Staff Legal Bulletin No. 14L, which has incentivized activists to submit proposals entirely unrelated to long-term value creation. Reversing the position in Staff Legal Bulletin No. 14L would signify a return to a proxy process focused on fostering business growth and enhancing investor value.

- Title VI – H.R. 4589, *a bill to amend the Securities Exchange Act of 1934 to provide for the registration of proxy advisory firms, and for other purposes*, was introduced on July 12, 2023, by Representative Bryan Steil. It would require proxy advisory firms to register with the SEC, establish protocols for managing conflicts of interest and mandate the disclosure of certain information. Under this title, proxy advisors would be required to provide economic analysis when evaluating social and political issues, aligning their recommendations with the fiduciary obligations of investment advisors. This title also bolsters transparency and accountability by compelling proxy advisors to share draft reports with issuers, disclose methodologies and information sources, and publish annual reports summarizing their activities. These measures seek to enhance the clarity and responsibility of proxy advisory firms in the corporate governance landscape.

- Title VII – H.R. 4590, *a bill to amend the Securities Exchange Act of 1934 to provide for liability for certain failures to disclose material information in connection with proxy voting advice, and for other purposes*, was introduced on July 12, 2023, by Representative Bryan Steil. It amends Section 14 of the Securities Exchange Act of 1934 to state that any failure to disclose material information or the inclusion of material misstatements in proxy voting advice would be deemed false or misleading concerning material facts under Section 18. Introducing liability for proxy advisory firms becomes crucial in safeguarding investors, preserving market integrity, fostering transparency, and establishing legal recourse for cases involving erroneous or misleading proxy voting guidance. Holding proxy advisory firms accountable for material misstatements or non-disclosures serves as a pivotal measure to foster accuracy, objectivity, and independence in their recommendations.

- Title VIII – H.R. 4648, *a bill to amend the Securities Exchange Act of 1934 to provide for duties of certain investment advisors, asset managers, and pension funds with respect to voting on shareholder proposals, and for other purposes*, was introduced on July 14, 2023, by Representative Barry Loudermilk. It requires that proxy advisor clients furnish beneficiaries and customers with annual reports detailing their voting behavior on shareholder proposals and whether those votes align with the recommendations provided by proxy advisors. It also requires larger entities to conduct economic analyses for votes contrary to board recommendations, which will subsequently be made public. These reforms empower investors with invaluable insights into the decision-making processes

of proxy advisory firm clients, enabling them to assess whether these firms are meeting their fiduciary obligations effectively. They also provide an elevated level of transparency, which fosters trust and enables investors to evaluate the alignment of voting decisions with their individual financial objectives effectively.

- Title IX – H.R. 4656, the *Protecting Americans' Savings Act*, was introduced on July 14, 2023, by Representative Zach Nunn. It prohibits robo-voting, and clarifies that individuals are not obligated to cast votes on proxy materials. The reforms in this title will compel institutional investors to critically evaluate proxy advisory firm recommendations, fostering due diligence and safeguarding the financial interests of retail investors.

B. H.R. 4790: The Guiding Uniform and Responsible Disclosure Requirements and Information Limits (GUARDRAIL) Act of 2023

H.R. 4790 was introduced on July 20, 2023, by Representative Bill Huizenga. It is a compilation of four previously introduced bills designed in response to SEC and EU actions that mandate non-material climate-related information. The reforms included in the *GUARDRAIL Act* are described in more detail below.

- Title I – H.R. 4168, the *Mandatory Materiality Requirement Act*, which was introduced on June 15, 2023, by Representative Bill Huizenga. The *Mandatory Materiality Requirement Act* would reinforce the foundational principles of the Securities Act of 1933 and the Securities Exchange Act of 1934 by mandating that disclosures made by issuers to the SEC must hold material significance concerning voting or investment decisions.

- Title II – H.R. 4628, *a bill to amend the Securities Exchange Act of 1934 to require the Securities and Exchange Commission to disclose and report on non-material disclosure mandates, and for other purposes*, was introduced on July 13, 2023, by Representative Alexander Mooney. This Title requires the SEC to disclose and report on non-material disclosure mandates, providing justifications for them at five-year intervals. It also specifies that companies will not be subject to private liability for their failure to disclose non-material information. The reforms in this Title aim to increase transparency, minimize legal risk, and provide clearer guidelines on the SEC's demands for non-material information.

- Title III – H.R. 4652, the *Public Company Advisory Committee Act*, was introduced on July 14, 2023, by Representative Frank Lucas. It would amend the Securities Exchange Act of 1934 to establish the Public Company Advisory Committee within the SEC. This committee will address an existing void by advising the SEC on rules and policies pertaining to its mission, which includes safeguarding investors, ensuring fair and efficient markets, and facilitating capital formation, all within the context of public companies

- Title IV – H.R. 4653, the *Protecting U.S. Business Sovereignty Act*, was introduced on July 14, 2023, by Representative Daniel Meuser. It directs the SEC to conduct a study on

the detrimental impact of the Directive on Corporate Sustainability Due Diligence and the Corporate Sustainability Reporting Directive on U.S. companies, consumers, investors, and the U.S. economy.[109] The study will offer critical insights, empowering policymakers, and regulators to make well-informed decisions concerning these EU directives.

C. H.J.Res. 127: Providing for Congressional Disapproval of the Climate Disclosure Rule

H.J.Res. 127 was introduced by Representative Bill Huizenga on April 9, 2024, to nullify the SEC's problematic Climate Disclosure Rule.[110] It received strong Republican support, earning 40 cosponsors, many of whom are Members of the House Committee on Financial Services. Given the Climate Disclosure Rule's well-documented flaws, H.J.Res. 127 is a necessary response to a glaring example of SEC overreach. Moreover, because the Climate Disclosure Rule is among the most expensive rules in the SEC's 90-year history, nullifying the rule would save companies costs that could otherwise prevent them from going or remaining public. H.J.Res. 127 sends a clear message that public companies and their investors should not be collateral damage in the SEC's wrongful efforts to use the securities laws to achieve the Biden Administration's progressive environmental policy goals.

D. H.R. 4655: The Businesses Over Activists Act

Congress should also consider H.R. 4655, which was introduced on July 14, 2023, by Representative Ralph Norman. H.R. 4655 would prohibit the SEC from compelling the inclusion or discussion of shareholder proposals and clarify that the agency does not have the authority to override state regulation of shareholder proposals or proxy materials. This would ensure that there is a proper balance between the SEC and state regulators. It would also curb SEC overreach, preventing the agency from continuing to venture into areas that are either not constitutionally permissible or are better served by another agency. The federal government should not force companies into discussions regarding politically motivated proposals, nor should it mandate that public companies subsidize activists' speech by publishing environmental and social proposals in their proxy materials. Thus, H.R. 4655 remains an option to shield companies and their shareholders from irrelevant and politically motivated proposals.[111]

3. Congressional Oversight: The House Financial Services Committee

A. SEC Climate Disclosure Investigation

On February 22, 2023, Chairman McHenry, Subcommittee Chairman Huizenga, and

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[109] *See* H.R. 4790, *the Guiding Uniform and Responsible Disclosure Requirements and Information Limits (GUARDRAIL) Act of 2023*, *available at* untitled (house.gov).

[110] See H.J.Res.127, *Providing for congressional disapproval under chapter 8 of title 5, United States Code, of the rule submitted by the Securities and Exchange Commission relating to "The Enhancement and Standardization of Climate-Related Disclosures for Investors.", available at* https://docs.house.gov/meetings/BA/BA00/20240417/117163/BILLS-118HJRes127ih.pdf.

[111] *See* H.R. 4655, *the Businesses Over Activists Act*, *available at* BILLS-118HR4655ih.pdf (house.gov).

Ranking Member Tim Scott of the Senate Banking, Housing, and Urban Affairs Committee sent a letter to Chair Gensler regarding the SEC's Climate Disclosure Rule.[112] The request highlights questions and concerns regarding the SEC's authority to promulgate such a overly burdensome rule and sought documents on matters related to the Rule no later than March 8, 2023.

Though the SEC has responded to the Committee, an overwhelming majority of the documents produced were publicly available and non-responsive to the requested documents. To date, the SEC has produced 82,315 pages of documents to the Committee related to the Climate Disclosure Rule. The non-public documents were authorized by the Commission for release to the Committee, while the remaining public documents produced are copies of the Climate Rule, Chair Gensler's public testimony from the 2021 hearing before the Committee, as well as the Chair's public calendar, speeches, and press releases.

Throughout the Congress, the Committee held four hearings dedicated to the SEC's harmful rule.[113] The hearings focused on the legal challenges tied to the rule upon finalization and the cost impact of the disclosures for businesses throughout the United States. Due to the SEC's limited document production, Chairman McHenry and Subcommittee Chairman Huizenga requested transcribed interviews from senior and lower-level staff at the agency directly involved in drafting the rule. Committee staff conducted three transcribed interviews with SEC Division Directors. Though the SEC is confident the final rule will withstand scrutiny, witnesses have acknowledged that the economic analysis included in the proposed rule is not sufficient to support the final rule.

B. Proxy Advisory Duopoly

In July 2023, the Subcommittee held a hearing to review the metrics that proxy advisory firms use to measure the impact of ESG policies on maximizing long-term value and identify what factors are prioritized when making voting recommendations.[114] Two of the largest proxy firms, Glass Lewis and ISS before the Subcommittee.[115] As discussed in the report, the firms' 97 percent dominance in the industry raises questions about bias, accountability, and oversight, as these firms have the power to influence institutional investors' voting decisions. Following the hearing, Subcommittee Chairman Huizenga sent letters to ISS and Glass Lewis requesting more information on their operations and practices that continue to push a radical left-wing agenda on American investors through ESG initiatives.[116]

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[112] Letter from Patrick McHenry, Chairman, H. Comm. on Financial Services, Bill Huizenga, Chairman, H. Comm. on Financial Services Subcommittee on Oversight and Investigations, Tim Scott, Ranking Member, S. Comm. Banking, to Gary Gensler, Chairman, Securities and Exchange Commission. (Feb. 22, 2023).

[113] *Oversight of the SEC: Hearing Before the H. Comm. on Financial Services*, 118th Cong. (2023), *Oversight of the SEC's Proposed Climate Disclosure Rule: A Future of Legal Hurdles: Hearing Before the H. Comm. on Financial Services*, 118th Cong. (2024), *Victims of Regulatory Overreach: How the SEC's Climate Disclosure Rule Will Harm Americans: Hearing Before the H. Comm. on Financial Services*, 118th Cong. (2024). *Beyond Scope: How the SEC's Climate Rule Threatens American Markets: Hearing Before the H. Comm. on Financial Services*, 118th Cong. (2024).

[114] *Oversight of the Proxy Advisory Industry: Hearing Before the H. Comm. on Financial Services*, 118th Cong. (2023).

[115] *Id.*

[116] Letter from Bill Huizenga, Chairman, H. Comm. on Financial Services Subcommittee on Oversight and Investigations, to Institutional Shareholder Service, Inc. and Glass, Lewis & Co. (July 20, 2023).

C. Fiduciary Responsibility of Asset Managers

In July 2023, Subcommittee Chairman Huizenga sent letters to ten asset management firms: BlackRock, Vanguard, State Street, J.P. Morgan Chase, T. Rowe Price, Prudential, Goldman Sachs, Fidelity, Capital Group Companies, and the Bank of New York Mellon.[117] The request highlights a lack of transparency surrounding the decisions asset managers make on behalf of millions of retail investors. The Subcommittee is conducting oversight on the ability of asset managers to fulfill their fiduciary responsibilities to prioritize financial returns and act in the shareholder's best interest.

[117] Press Release, Congressman Bill Huizenga, Huizenga Opens Inquiry Into How Asset Managers Fulfill Their Fiduciary Responsibility (July 18, 2023), https://huizenga.house.gov/news/documentsingle.aspx?DocumentID=402668.