MEMORANDUM

TO: Republican Members, House Committee on Financial Services
FROM: ESG Working Group, House Committee on Financial Services
RE: Preliminary Report on ESG Climate Related Financial Services Concerns
DATE: June 23, 2023

Summary and Key Priorities

The Environmental, Social, and Governance (ESG) Working Group was created at the beginning of this Congress for the specific purpose of developing a policy agenda designed to protect the financial interest of everyday investors from progressive activists who are using our institutions to force far-left ideology on Americans. The Working Group has met with key stakeholders to facilitate open dialogue on the impact of ESG policies on our capital markets. This memorandum explores the key priorities and issues that the Working Group has identified to date and will continue to focus on throughout the 118th Congress.

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 EU regulations, safeguarding American interests in global markets.

Introduction

The prioritization of ESG by the Biden Administration through regulatory measures is a deliberate strategy aimed at circumventing the lack of congressional support for certain environmental, social, and political policy issues. Faced with the inability to pass these initiatives through traditional legislative channels, the administration is exploiting financial regulatory agencies to impose their policy and other ESG-related priorities on the private sector.

It is essential to carefully evaluate the implications of this prioritization on retail investors, who heavily rely on the profitability and success of companies for their financial well-being. Moreover, it is imperative that corporate boardrooms not develop into partisan platforms where political agendas overshadow sound financial management.
To address these concerns, the primary objectives of the Working Group are twofold: firstly, to examine the implementation of a partisan and progressive agenda on investors, and secondly, to identify policies and practices that protect investors and our capital markets. The initial focus of the Working Group centers on the environmental aspect, specifically the current promotion of environmental policies in the financial services industry and by regulatory bodies. This memorandum aims to analyze key themes and shed light on critical areas, such as the prevalence of ESG shareholder proposals, the undue influence exerted by proxy advisory firms, and the detrimental impact on economic performance.

Furthermore, the memo emphasizes key concerns about the Securities and Exchange Commission (SEC) exceeding its statutory authority by mandating non-material ESG disclosures through regulations, thereby circumventing the legislative process. Additionally, the Working Group will continue to explore the broader landscape of climate-related initiatives pursued by independent agencies and the potential extraterritorial impact of disclosure regulations contemplated by European authorities on U.S. public companies. Finally, the Working Group will continue to underscore the fact that ESG initiatives often fail to generate robust financial returns, while the concentration of control within proxy advisory firms and certain influential asset managers raises significant doubts about the credibility and efficacy of the ESG movement.

**Background**

I. Reforming the Proxy Voting System for Retail Investors

The current administration at the SEC is more focused on climate change and social justice than protecting investors. In 2021, the SEC implemented changes that made it easier for politically motivated proposals to be included in annual proxy statements. This resulted in a 51 percent rise in environmental proposals and a 20 percent increase in social proposals. Chair Gensler’s use of the SEC as a political tool is deeply concerning, as it puts the investments of hard-working Americans at risk and sets a dangerous precedent of weaponizing the agency for progressive purposes.

Shareholders have the right to protect their investments and participate in corporate decision-making. However, the SEC rules have allowed social activists to abuse the proxy system. With just $2,000 worth of company stock, these activists are submitting hundreds of resolutions related to environmental, social, and political issues, rather than focusing on the company’s growth and competitiveness.

For example, in 2022, politicized investors at Comcast proposed that the company report on its retirement plan options in relation to climate action goals.¹ This attempt to use retiree funds for political purposes could have resulted in lower returns or higher risk for investors if it had been successful. Similarly, other proposals, such as demanding a racial equity audit from

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Home Depot or climate targets from Costco have no material impact on the company’s financial performance.

Last year, ESG shareholder proposals accounted for 61 percent of all proposals on proxy ballots, nearly double the previous year’s count. Numerous studies show that ESG-related 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. Moreover, these extraneous ESG proposals impose substantial costs on companies and their shareholders, without holding the proponents accountable.

The proxy voting system is in dire need of reform to strengthen shareholder engagement, promote transparency, and eliminate inefficiencies. The system must be modernized to enhance corporate governance and ensure that the proxy system operates in the best interests of shareholders.

a. Reforming the Rule 14a-8 No-Action Letter Process

The rise of ESG-related shareholder proposals can be attributed to the SEC’s decisions that create ambiguities in the Rule 14a-8 no-action letter process. For example, in November 2021, the SEC issued new guidance that will make it difficult for companies to exclude ESG shareholder proposals. More specifically, Staff Legal Bulletin No. 14L states the SEC will now focus on the social policy significance of issues raised by shareholder proposals, rather than an individual company’s connection to the particular issue. As a result, companies have become far less likely to seek no-action relief from the SEC, despite the unprecedented number of ESG shareholder proposals being filed. At a recent 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 same time last year.

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

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and promote greater accountability, it is crucial that Congress revise the SEC no-action letter process.

b. Improving 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 communication, printing, mailing, and vote tabulation contribute to these expenses. Surprisingly, it is the company and all its shareholders who bear these costs, not the shareholder-proponent. This disconnect must be addressed by Congress.

Under current SEC rules, even small shareholders who meet the $2,000 ownership requirement for at least three years can submit proposals on public company ballots. This process is overwhelmingly exploited by activists driven by social or political agendas, leading to an increasing number of ESG-related shareholder proposals. 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. As a favorable recommendation from a proxy advisor firm can easily garner 25 investor percent support, shareholder proposals backed by proxy advisors can be resubmitted indefinitely, even if they don't necessarily serve the long-term interests of companies and retail investors.8

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 addressing substantially the same subject matter as prior proposals that received minimal support.9 These proposed changes will result in significant abuse and circumvention of the rule, allowing activists to resubmit previously rejected proposals by making minor modifications to the text of the proposals.

To promote a fair and representative decision-making process, it is essential to raise the thresholds for submitting and resubmitting shareholder proposals. By doing so, effective shareholder engagement can be maintained, and the rights and interests of all shareholders can be protected.

II. Ensuring the Accountability of Proxy Advisory Firms

The outsized influence of proxy advisory firms on the proxy voting system is a growing concern. Proxy advisory firms, such as Institutional Shareholder Services (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

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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 expertise and guidance of proxy advisors. 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.

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.\(^{10}\) The SEC emphasized that proxy voting advice typically counts 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.\(^{11}\)

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.\(^{12}\) 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 issues. 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.\(^{13}\)

Less than two months on the job, 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


\(^{12}\) See SEC Release, supra note 10.

\(^{13}\) 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).
solicitation. Following Gensler’s directive, SEC staff announced that it would not recommend enforcement actions pursuant to the adopted 2020 rule and proposed amendments that repealed most of the protections in the 2020 rules (the “Redo Proposal”).

In July 2022, the SEC adopted the Redo Proposal, though nothing had changed to justify repeal. During the proposal’s brief comment period, many commenters were baffled by the “regulatory whiplash.” By reversing the 2020 reforms prior to them going into effect, commentators noted that the SEC failed to provide serious evidence of new or changed circumstances to justify its actions. Commenters also found 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. Protecting Retail Investor Interests

One of the key concerns with proxy advisory firms is their tendency to overlook the economic impact of shareholder proposals. By prioritizing social and political issues over financial analysis, 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 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.

In order to achieve a fair and transparent corporate governance landscape that safeguards retail investors’ interests, there must be accountability measures for proxy advisors and 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 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

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value and long-term prospects, rather than relying solely on the social or political policy preferences of proxy advisors.

c. **Promoting Transparency and Accountability**

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. One critical reform is the requirement for proxy advisors to publish an annual report that provides 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 were 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. **Ensuring Investors Have Access to Accurate Information**

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 be required to engage in open and constructive communication with issuers, allowing the opportunity to respond to and rectify any inaccuracies in the advisory reports.

To ensure accuracy and accountability, proxy advisory firms should be mandated to share draft reports with issuers before they are disseminated. This vital step allows companies to thoroughly review the reports, 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 be compelled to 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 requirements promote a fair and reliable advisory process, fostering trust between issuers, investors, and proxy advisors.
III. Enhancing Accountability in Shareholder Voting

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. In order to restore accountability and ensure fiduciary obligations are met, it is imperative that legislative reforms are implemented. These reforms include policies that will better align voting decisions 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. While the SEC’s Staff Legal Bulletin 20 provides a starting point for this oversight, it is necessary to examine whether institutional investors are genuinely fulfilling their fiduciary duties when relying on these firms’ recommendations.19 The concern arises when institutional investors blindly follow proxy advisory recommendations without conducting thorough evaluations. 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 exercise their fiduciary duties by critically evaluating recommendations and ensuring they align with the best interests of their clients. The prohibition of robo-voting, the practice of automatically casting votes consistent with proxy advisor recommendations, will prevent hasty and uninformed decisions, encouraging investors to engage in thorough analysis before casting their votes. Moreover, by removing the robo-voting mechanism, institutional investors will be compelled to critically evaluate proxy advisory firm recommendations before casting their votes. This shift will allow for greater due diligence, thereby protecting the economic interests of retail investors.

b. Enhancing Transparency

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.

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19 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).
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, 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.

IV. 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. One such example is the participation of many large asset managers as signatories to an international commitment to pursue net zero emissions by 2050. This commitment requires, among other things, that asset managers prioritize emissions reductions within the sectors and companies in which they invest. The promotion of a social or political agenda like this raises questions about transparency, accountability, and the impact on retail investors.

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 one-quarter at shareholder meetings of most S&P 500 companies. Despite being labeled as passive investors, they actively utilize

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22 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.
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. In an effort to clarify its independence on investment decision, the entity withdrew from the Net Zero Asset Managers Initiative.

b. Transparency and Regulatory Gaps

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, inhibiting regulatory assessments of their policy implications.

Congress should review 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. Congress should explore legislation to provide a more precise definition of “control” to prevent potential regulatory loopholes. 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.

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

ESG rating agencies have garnered significant attention in recent years for their role in providing information about the ESG performance of companies. These ratings are used by investors, analysts, and corporate managers to guide their investment decisions. There are serious concerns about the reliability and impact of ESG rating agencies, particularly on retail investors.

24 Id.
a. Lack of Standardization and Transparency

One of the major issues with ESG ratings is the inconsistent rankings assigned to the same company by different rating providers. 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. 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. There is little correlation between ESG ratings and subsequent risk events or financial performance.

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 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. Another study assessed the performance of companies at the onset of Covid-19 and found no evidence that ESG ratings predict performance during the

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unexpected risk event.\textsuperscript{27} 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.\textsuperscript{28} These findings highlight the need for 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.

VI. The Politicization of the SEC

Administrative law allows executive agencies to act only when empowered by Congress.\textsuperscript{29} In the SEC’s case, the Securities Act and the Exchange Act (together, the “Acts”) 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 for advancing the objectives of the Acts.

The Supreme Court’s recent ruling in \textit{West Virginia v. EPA} reaffirmed the position that a government agency’s rulemaking authority is not unlimited. In that case, the Court ruled that the major questions doctrine requires a government agency to point to clear congressional authorization for 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.

Under Chair Gensler’s leadership and direction, the SEC has and continues to exceed its statutory authority.\textsuperscript{30} For instance, Congress has not granted the SEC the authority to create regulations that compel companies to disclose general information about ESG-related issues.\textsuperscript{31} 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.\textsuperscript{32}

\textsuperscript{27} 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).


\textsuperscript{31} See \textit{The Enhancement and Standardization of Climate-Related Disclosure for Investors, 17 CFR 210, 229, 232, and 249.}

a. Undermining the Materiality Standard

The SEC’s pursuit of ESG disclosure initiatives threatens to undermine the Commission’s materiality standard. The materiality standard has been the touchstone of our public company disclosure regime since the concept was first included in the Securities Act of 1933 and the Securities and Exchange Act of 1934. Under the principles-based materiality standard, a company must disclose information to prospective investors and shareholders so that they can make informed investment and proxy voting decisions. With respect to ESG information, public companies are already required to make disclosures under current law when such information is material.

The SEC should only be able to impose disclosure requirements when the Commission expressly determines that there is a substantial likelihood that the information is material to investors. By maintaining a clear and stringent threshold for disclosure, this approach protects investors by focusing on information that is truly important for their investment and proxy voting decisions.

b. Climate Risk Disclosures

On March 21, 2022, the SEC proposed a 500-page climate disclosure rule that would replace voluntary sustainability reports with mandatory disclosures that include detailed emissions data and climate risk management strategies. On February 22, 2022, Chairman Patrick McHenry, Senate Committee on Banking, Housing, and Urban Affairs Ranking Member Scott, and Subcommittee on Oversight & Investigations Chairman Huizenga sent a letter to the SEC requesting documents and information related to the climate disclosure rule. The Committee continues to seek information and documents to determine what analysis the SEC used in developing the rule.

Moreover, the SEC does not have the legal authority to enforce climate-focused regulations, and the rule compromises the traditional concept of materiality. The SEC’s proposal could also be in violation of the First Amendment, the non-delegation doctrine, and

33 17 CFR § 230.405.
36 The proposed rules risk 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.
37 The Proposal 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. 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.
will discourage companies from entering or remaining in the public markets.\textsuperscript{38}

Additionally, the SEC’s proposal would also elicit disclosure about a board’s oversight of climate-related matters. This information includes whether directors have expertise in climate-related risks, the frequency of board discussions on climate matters, and how a board sets climate-related targets and oversees its progress. The proposal effectively dictates expectations for how a company’s governance on climate should be structured, while failing to explain why this would be important for all companies at the board level. Put simply, the proposal is an example of the SEC driving companies to create boards filled with “specialty directors” who have deep but narrow knowledge and struggle to fulfill the broad oversight and related duties that are required.\textsuperscript{39}

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.\textsuperscript{40} 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.

The SEC is planning to propose a new rule that would introduce additional qualitative and quantitative disclosures related to workforce management.\textsuperscript{41} Unlike the previous Chair’s principles-based approach, 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.

d. SEC No-Action Letter Process

Exploiting the shareholder proposal process for social and environmental causes ultimately undermines shareholder value for retail investors. The recent surge in ESG-related proposals adds unnecessary pressure on corporate boards, wastes corporate resources, and

\textsuperscript{38} 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.

\textsuperscript{39} The SEC’s rationale could be extended to justify similar expectations for board experts on pandemics, geopolitical affairs, macroeconomics, or even taxation.


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 for proposals to be relevant to a company’s business. 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 and granting companies greater autonomy in developing their own shareholder proposal procedures. By recognizing that corporate governance is primarily the responsibility of the company and its shareholders, decision-making should remain in the hands of those directly impacted.

e. Other ESG-Related Initiatives

In addition to its proposed climate disclosure rule, the SEC has focused on other climate-related endeavors outside of the SEC’s mission. 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. Rather than suddenly viewing itself as a climate change regulator, the SEC should return to focusing on its clear statutory mission.

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

The European Union’s (EU) recently implemented Corporate Sustainability Reporting Directive (CSRD) and the proposed Corporate Sustainability Due Diligence Directive (CS3D) impose significant burdens on U.S. companies. These directives have 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

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 Scope 3 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 various sectors of the U.S. economy.

CS3D, proposed by the EU, poses even greater concerns than CSRD. This directive would capture a higher number of U.S.-based companies, particularly those in "high-impact sectors." These sectors include textiles, agriculture, fuels, chemicals, and more. Companies operating within these industries would be subject to the rule if their EU revenues reach a de minimis threshold of $40 million. CS3D not only requires disclosure but also mandates the identification, mitigation, and resolution of adverse environmental and social impacts. 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, the CSRD and CS3D rulemakings represent an unprecedented intrusion into the U.S. economy. The lack of action by the Biden Administration to prevent or negotiate an equivalent agreement undermines the protection of U.S. companies and their operations.