

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

July 5, 2019

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: July 10, 2019 Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Hearing entitled: “Building a Sustainable and Competitive Economy: An Examination of Proposals to Improve Environmental, Social, and Governance Disclosures”

On Wednesday, July 10, 2019 at 2:00 p.m., the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, “Building a Sustainable and Competitive Economy: An Examination of Proposals to Improve Environmental, Social, and Governance Disclosures.” Witnesses for the hearing are:

- Tim Mohin, Chief Executive, Global Reporting Initiative (GRI)
- James Andrus, Investment Manager-Financial Markets, Sustainable Investment, CalPERS Investment Office
- The Honorable Paul S. Atkins, Chief Executive Officer, Patomak Global Partners
- Degas A. Wright, CFA, Chief Executive Officer, Decatur Capital Management, Inc.
- Mindy S. Lubber, President and Chief Executive Officer, Ceres

Overview of Disclosure Regime

All U.S. public companies¹ are required to file periodic and current reports with the Securities and Exchange Commission (SEC) disclosing certain business and financial information about the company.² The purpose of these reports is to provide investors with the information they need to make informed investment and voting decisions.³ Robust disclosure helps to mitigate the significant information asymmetries between management of a company and shareholders;

¹ Public companies are companies that are subject to the reporting requirements of section 13 or section 15(d) of the Securities Exchange Act of 1934 [15 U.S.C. 78a *et seq.*]. When this memo uses the term “companies,” it is referring to public companies.

² See *e.g.*, Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)].

³ See H.R. REP. NO. 73-85, at 4 (1933) (“The type of information required to be disclosed is of a character comparable to that demanded by competent bankers from their borrowers, and has been worked out in light of these and other requirements. They are ... adequate to bring into full glare of publicity those elements of real and unreal values which may lie behind a security.”).

enables shareholders to hold managers accountable and to make consistent cross-company comparisons; and enhances the accuracy of stock prices, leading to a more efficient allocation of capital.⁴

Federal securities law provides the SEC with broad authority to write rules requiring the disclosure of specific information that it determines to be in the public interest or for the protection of investors.⁵ The SEC’s Regulation S-K (Reg S-K) establishes the disclosure requirements for all ongoing reporting requirements (other than financial statement disclosures).⁶ Reg S-K generally requires companies to disclose information that is reasonably likely to have a material effect on a company’s financial condition or its operating performance.⁷ Information is considered “material” if there is a substantial likelihood that a reasonable investor would consider the information important in deciding how to make an investment or voting decision.⁸ The Supreme Court has further explained that information is “material” if there is a substantial likelihood that disclosure of the omitted fact would have been viewed by a reasonable investor as significantly altering the “total mix” of information available.⁹

However, Reg S-K does not require companies to *only* disclose information that meets the standard of “materiality,” and the SEC has broad authority to require the disclosure of information if it would be in the public interest or would protect investors.¹⁰ In fact, the SEC’s approach to Reg S-K has historically been to identify broad categories of information that it believes are material to investors, and then to rely on a mix of: (1) specific line-items within those categories; and (2) management discretion to determine additional information within each category that is material to its own business and financial results.¹¹ Moreover, Congress can — and has — mandated additional disclosures when there is a public policy interest at stake.¹²

⁴ See Henry T. C. Hu, *Disclosure Universes and Modes of Information: Banks, Innovation, and Divergent Regulatory Quests*, 31 *Yale J. on Reg.* 565, 619 (2014); see also SEC, BUSINESS AND FINANCIAL DISCLOSURE REQUIRED BY REGULATION S-K: CONCEPT RELEASE, 81 Fed Reg. 23916, at 23921 (April 22, 2016) (noting that “investors must have access to accurate information important to making investment and voting decisions in order for the financial markets to function effectively”).

⁵ See e.g., Section 12(b)(1)(A) of the Exchange Act [15 U.S.C. § 78l].

⁶ See generally 17 C.F.R. part 229.

⁷ See e.g., SEC, COMMISSION GUIDANCE REGARDING MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (December 29, 2003), available at <https://www.sec.gov/rules/interp/33-8350.htm> (noting that “companies must identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance”).

⁸ See *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988); see also 17 CFR § 240.12b-2 (defining “material”).

⁹ See *Basic*, 485 U.S. at 231.

¹⁰ See SEC, BUSINESS AND FINANCIAL DISCLOSURE REQUIRED BY REGULATION S-K: CONCEPT RELEASE, 81 Fed Reg. at 23921 (“The Securities Act and the Exchange Act authorize the Commission to promulgate rules for registrant disclosure as necessary or appropriate in the public interest or for the protection of investors.”).

¹¹ See *id.* at 23924–23925.

¹² See e.g., Iran Threat Reduction and Syria Human Rights Act of 2012, Pub. L. No. 112-158, § 219, 126 Stat. 1214 (2012) (requiring public companies to disclose any contacts with, or support for, Iran or certain other persons involved in terrorism or the creation of weapons of mass destruction).

Environmental, Social, and Governance (ESG) Disclosures

Environmental, social, and governance (ESG) matters generally include issues relating to environmental sustainability, such as climate change; social issues such as human rights and labor practices; and governance issues such as gender, racial, and ethnic diversity at both the executive and board levels.

There is growing evidence that ESG disclosures are material to investors. In recent years, investors have increasingly been demanding more — and better — disclosure of ESG information from public companies.¹³ Many investors view ESG information as important not just for evaluating reputational risks, but for evaluating companies' *financial* performance as well.¹⁴ For example, Blackrock Investment Institute stated in a 2015 report that:

ESG factors cannot be divorced from financial analysis. We view a strong ESG record as a mark of operational and management excellence. Companies that score high on ESG measures tend to quickly adapt to changing environmental and social trends, use resources efficiently, have engaged (and, therefore, productive) employees, and face lower risks of regulatory fines or reputational damage.¹⁵

Moreover, credit rating agencies now incorporate ESG factors into their ratings methodologies — in fact, S&P has taken over 100 rating actions based on environmental and climate concerns.¹⁶

In recognition of the growing importance of ESG disclosures in the investment landscape, the International Organization of Securities Commissions (IOSCO) published a statement on January 18, 2019 emphasizing “the importance for issuers of considering the inclusion of environmental, social and governance (ESG) matters when disclosing information material to

¹³ See e.g., Donnelly Financial, *The Future of ESG and Sustainability Reporting: What Issuers Need to Know Right Now*, at 3 (November 14, 2018) (finding that 65% of institutional investors “often or always consider environmental and social issues in their investment decisions,” and 95% “often or always consider governance issues — for all investments.”).

¹⁴ See e.g., Bank of America, *ESG: Good Companies Can Make Good Stocks*, at 1 (December 18, 2016) (finding that “[ESG] metrics have been strong indicators of future volatility, earnings risk, price declines and bankruptcies.”); Nordea, *Cracking the ESG Code*, at 1 (September 5, 2017) (“Companies that score higher on ESG demonstrate better operational performance, with regards to both the level and the stability of returns.”).

¹⁵ Blackrock Investment Institute, *The Price of Climate Change: Global Warming's Impact on Portfolios*, at 7 (October 31, 2015).

¹⁶ Standard & Poor's, *How Does S&P Global Ratings Incorporate Environmental, Social, and Governance Risks Into Its Ratings Analysis*, at 2 (November 21, 2017) (noting that between July 16, 2015 and August 29, 2017, “environmental and climate (E&C) concerns affected corporate ratings in 717 cases, or approximately 10% of corporate ratings assessments and resulted in a rating impact (an upgrade, downgrade, outlook revision, or CreditWatch placement) in 106 cases.”).

investors' decisions."¹⁷ However, while the SEC is a member of IOSCO, it was the only member regulator not to sign on to the IOSCO statement on ESG disclosures.¹⁸

In October 2018, a coalition of large public pension funds, asset managers, law professors, and non-profit organizations filed a petition with the SEC for a rulemaking on ESG disclosures.¹⁹ The petition called on the SEC to develop a comprehensive ESG disclosure framework, and identified seven specific issues that the SEC could act on immediately: (1) climate risk; (2) annual ESG disclosures based on the Global Reporting Initiative (GRI) framework; (3) gender pay ratios; (4) human capital management; (5) human rights; (6) political spending; and (7) tax disclosure.²⁰

In addition, over 2,300 investment managers, asset managers, and service providers representing over \$80 trillion in assets under management (AUM) are signatories to the UN-sponsored Principles for Responsible Investment (PRI), which commit these institutions to incorporating ESG factors into their investment decisions.²¹ Of these signatories, 458 are U.S. institutions, which collectively represent over \$40 trillion AUM.

Legislative Proposals

H.R. ____: ESG Disclosure Simplification Act of 2019 (Rep. Vargas): This bill requires public companies to disclose certain ESG metrics, which the SEC is required to establish in a rule.²² The bill also requires public companies to disclose annually in their proxy statements a description of the company's views on the link between ESG metrics and long-term business performance, as well as the process the issuer uses to determine such impacts. In addition, the bill includes a sense of Congress that the ESG metrics that the SEC establishes are automatically deemed material to investors. Finally, this bill creates a Sustainable Finance Advisory Committee within the SEC, which would make recommendations to the SEC on which ESG metrics public companies should be required to disclose; would submit a report to the SEC within 18 months that identifies challenges and opportunities for investors in sustainable finance; and would periodically recommend policy changes that would encourage the flow of capital toward sustainable finance.

H.R. ____: Shareholder Protection Act of 2019: This bill requires public companies to submit quarterly reports to both the SEC and investors detailing the amount, date, and nature of the company's expenditures for political activities. If the political expenditure was made in support of

¹⁷ IOSCO, *Statement on Disclosure of ESG Matters by Issuers*, at 1 (January 18, 2019), available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD619.pdf>.

¹⁸ See *id.* at 1, n. 1.

¹⁹ Cynthia A. Williams, Jill E. Fisch, et al., *Request for Rulemaking on Environmental, Social, and Governance (ESG) Disclosure*, File No. 4-730 (October 1, 2018), available at <https://www.sec.gov/rules/petitions/2018/petn4-730.pdf>.

²⁰ See *id.* at 13–16.

²¹ PRI is a non-profit organization, originally formed by the United Nations in 2006, that brings together the world's investment community in order to promote responsible investment and encourages investors to use responsible investment. See About the PRI, available at <https://www.unpri.org/pri/about-the-pri>.

²² The bill authorizes the SEC to delay the phase-in of these rules for small issuers.

(or opposition to) a particular candidate, or was made to a trade association, then the company must disclose the candidate and/or trade association. The bill also requires public companies to disclose in their annual reports any political expenditures over \$10,000 in the previous year, as well as the nature and amount of any political expenditures the company plans to make in the upcoming year.

H.R. ____: Corporate Human Rights Risk Assessment, Prevention, and Mitigation Act of 2019: This bill requires public companies to annually identify — and rank by severity — any human rights *risks* or human rights *impacts* in their value chains. Companies must also disclose any actions they have taken to avoid or mitigate the human rights risks and impacts identified in the annual report, or, if no action was taken, an explanation for why the company took no action.

H.R. ____: To require issuers required to file an annual or quarterly report under the Securities Exchange Act of 1934 to disclose the total amount of corporate tax such issuer paid in the period covered by the report, and for other purposes: This bill requires public companies to disclose (in their 10-Qs and 10-Ks) their total pre-tax profits, and total amounts paid in State, Federal, and foreign taxes. The bill also requires companies to disclose a number of specific tax-related items for each of its subsidiaries, as well as on a consolidated basis, such as total accrued tax expenses, stated capital, and total accumulated earnings.

H.R. ____: Climate Risk Disclosure Act of 2019 (Rep. Casten): This bill requires public companies to disclose in their annual reports information relating to the financial and business risks associated with climate change. The bill also requires the SEC to establish, in consultation with other relevant Federal agencies, climate-related risk disclosure metrics and guidance, which will be industry-specific, and will require companies to make both quantitative and qualitative disclosures.