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THE APPLICATION OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE PRINCIPLES IN INVESTING AND THE ROLE OF ASSET MANAGERS, PROXY ADVISORS, AND OTHER INTERMEDIARIES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SIXTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE EVOLUTION OF ESG CONSIDERATIONS BY INSTITUTIONAL INVESTORS AND HOW INVESTORS ENGAGE WITH COMPANIES ON ESG ISSUES

APRIL 2, 2019

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C O N T E N T S

TUESDAY, APRIL 2, 2019

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

THE APPLICATION OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE PRINCIPLES IN INVESTING AND THE ROLE OF ASSET MANAGERS, PROXY ADVISORS, AND OTHER INTERMEDIARIES

TUESDAY, APRIL 2, 2019

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. The Committee will come to order.

Today's hearing will focus on the role of asset managers, proxy advisors, and retail investors in engaging with companies on environmental, social, and governance issues.

Last year, Chairman Clayton expressed concerns that the "voices of long-term retail investors may be underrepresented or selectively represented in corporate governance."

Regardless of the tools that retail investors choose for investing their hard-earned money, it is critical that they have a voice in investment decisions that are being made.

Whether it is a company's use of a proxy advisory firm or an asset manager's investment decision-making policy, the retail investor should have a clear understanding of the decisions that are being made which ultimately represent their shares.

Last year, John Bogle, the creator of the index fund, wrote an oped in the *Wall Street Journal* about how successful the index fund has been for investors, noting that if historical trends continue, a handful of institutional investors will 1 day hold voting control of virtually every large U.S. corporation.

Even at existing levels, as consumers continue to use index funds, there has been an evolution in the concentration of control now held by a small group of asset managers voting a huge number of shares.

Today index funds hold 17.2 percent of all U.S. shares and are the largest shareholder in 40 percent of all U.S. companies.

With the exception of socially responsible funds, most funds are not targeted at specific environmental or social impact objectives, and many investors in these funds do not expect asset managers

to engage companies on social and environmental issues on their behalf.

However, since the 2014 proxy season, institutional shareholders support for inclusion of environmental and social proposals has increased from 19 to 29 percent while retail shareholder support has increased marginally to only 16 percent.

In the 2018 proxy season, ESG proposals were the largest category of shareholder proposals on proxy ballots with 15 percent of proposals climate-related and 14 percent related to political contributions.

It is important to understand how institutional investors are voting the shares of the money they manage to make sure that retail investors' interests are being reflected in these voting decisions.

Today I look forward to hearing from our witnesses on the following questions: How are the retail investors being engaged within the proxy voting process and in setting the policies used by the asset managers of the passive funds with which they invest? Are these shares being voted to drive productivity in our economy and increase investors' return on their hard-earned investments, or are intermediaries using other people's money unbeknownst to them in order to advance environmental, social, and other political policies? What financial and other criteria are used in identifying social issues for engagement and measuring engagement success for end investors?

I look forward to hearing the views of all of our witnesses on these issues, and, again, I thank them for coming here and their willingness to appear today.

Senator Brown.

OPENING STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Chairman Crapo. Welcome to our witnesses.

I hope today's hearing will allow the Committee to better understand the growth of environmental, social, and governance—ESG—investing principles.

Corporations have become beholden to quarterly earnings reports. One survey of financial executives from public companies found that 78 percent would sacrifice economic value of their own company just to meet financial reporting targets, telling us something, of course, about—well, about their own compensation perhaps.

That is no way to grow our economy.

Families do not think in terms of 3-month earning quarters. They think in terms of school years, 30-year mortgages, and years left to save for retirement. The more corporations think about the long-term sustainability of their businesses, the better off that workers and shareholders and managers and customers will be.

Corporations spent more than $800 billion on stock buybacks last year. That money does not end up in the pockets of the company's workers. It goes right in the pockets of the CEOs and other corporate managers making that decision.

Last year, for the first time in a decade, corporations spent more on their own stock than on investing in long-term capital expenditures and worker investments.

I will say that again. Corporations spent more on their own stock than on investing in long-term capital expenditures and worker investments.

We know when companies ignore long-term risks, workers, small-time investors, and consumers all pay the price.

Look at Wells Fargo, in the news a lot lately. The company exploited its workers with unsustainable expectations to boost its stock value, while the board lavished CEOs with pay raise after pay raise. And consumers still pay the price.

It is not just consumers. It is bad for the company. Wells Fargo has faced scandal after scandal, fines and enforcement actions, and the worst stock performance among the biggest banks. Just last week, for the second time in 2½ years, the CEO stepped down under the cloud of the scandals.

Study after study tells us that investors who pay attention to how companies affect workers and communities and the environment do better over time.

But it is not always easy to figure out which companies are thinking long term and which companies are only thinking about the next round of stock buybacks. We need to make that critical information available to the public.

Most of the SEC's disclosure requirements were adopted 40 years ago, when more than 80 percent of S&P 500 companies' assets were fixed, like buildings and factories. Today the numbers are flipped. More than 80 percent of S&P 500 assets are intangible—brand names, patents, and investments to enhance worker skills and effectiveness.

To address that evolution, the SEC Investor Advisory Committee last Thursday recommended to the Commission that companies include new human capital management disclosures in their public filings.

Adding human capital disclosure is just a start. Investors know there are many environmental, social, or political risks that could reduce long-term value, but companies are not providing that information.

So the SEC should act. Enhancing and standardizing these disclosure requirements will bring the SEC up to date with other rules around the world.

But disclosure is just one step. It is time that companies realize that holding executives and directors accountable, about respecting workers and the dignity of work, about planning for long-term risks instead of short-term payouts for CEOs is actually good for business.

Instead, corporations spend their time lobbying against important tools that allow shareholders to hold corporate boards and management accountable.

Corporate special interests want to limit investors' freedom to manage and run their funds. They want to silence the voices of Main Street investors by making it harder for shareholders to petition companies to allow all shareholders to vote on issues significant to the company.

Never mind that corporations never want Government to step in to protect servicemembers from banks that repossess their cars or protect families from getting trapped in a downward spiral of debt

with a payday lender—subjects that should be topics of hearings rather than this.

But now all of a sudden, these rich CEOs want Government to step in to protect them from ordinary investors and ordinary Americans who are trying to make their voices heard on climate change, on protecting Americans from gun violence, on treating workers with respect. So much for limited Government.

Just a sidelight, Mr. Chairman. The legislature in Columbus is about to pass legislation that would allow anyone over 19 to carry a concealed weapon without a permit and with no training. It also eliminates the requirement that, if stopped, a suspect has to notify the police officer that that suspect is carrying a gun. Take away all those protections, and sometimes stockholders speak up, and we have to protect the pampered CEO from those stockholders, apparently.

It should not take a crisis to focus executives and directors on the essentials of long-term planning. But too often short-term thinking takes over; workers, shareholders, and customers suffer. Just ask Wells Fargo.

I look forward to hearing from the witnesses.

Chairman CRAPO. Thank you, Senator Brown.

Today's witnesses are the Honorable Phil Gramm, a former United States Senator from Texas and former Chairman of this Committee. Welcome, Senator Gramm.

Also, Mr. James Copland, senior fellow and director of legal policy at the Manhattan Institute.

And Mr. John Streur, president and chief executive officer at Calvert Research and Management and Eaton Vance Company.

Again, thank you all for being here today. Your written testimony has been entered into the record, and we encourage you each to try to stick with your 5 minutes. Watch the clock there, please. And, Senator Gramm, you may proceed.

STATEMENT OF PHIL GRAMM, FORMER U.S. SENATOR

Mr. GRAMM. Well, Mr. Chairman, first—let me see. Maybe I better turn on my mic. First, thank you for inviting me. And, Senator Brown, I am very proud to be here. I spent 18 years on this Committee, the best part of it when I served as Chairman, and so I am glad to be back here.

I came back today, I accepted your invitation because I believe this is a very important subject. I believe that how corporate governance is structured and who money works for will have a profound impact on our future prosperity and freedom. I respect the opinion and the good intentions of those who would collectivize corporate America's structure, but I believe such policies would hurt the very people they seek to help. And let me explain why.

The Enlightenment, which was centered in the 1700s, liberated the mind, the soul, and property by empowering people to think their own thoughts, worship their own gods, and benefit from the fruits of their own labor and thrift. As labor and capital came to serve their owner, not the crown, the guild, the church, or the village, medieval economies awakened from a thousand years of stagnation. The Parliament in England stripped away the leaching influence of royal charters and initiated reforms that ultimately al-

lowed businesses to incorporate by simply meeting preset capital requirements. Parliament further established in law the principle that business would be governed by the laws it passed, in a process of open deliberation, not by the corrosive influences and rampant cronyism that were pervasive in the medieval marketplace.

The Enlightenment recognized that the crown, guild, church, and village had become rent seekers, leaching away the rewards for work, thrift, and innovation and in the process reducing productive effort and progress. The Enlightenment principle that labor and capital were privately owned property, not communal assets subject to involuntary sharing, unleashed an explosion of knowledge and production, creating a never before equaled human flourishing that continues to this day.

Extraordinarily, today in America, the crown jewel and greatest beneficiary of the Enlightenment, political movements are afoot that seek to overturn the individual rights created in the Enlightenment and return to a medieval world of subjects and subjugation. Today we hear proposals to force businesses to swear medieval fealty to stakeholders—the modern equivalent of crown, guild, church, and village—the general public, the workforce, the community, the environment, societal factors. These stakeholders would not have to stake any of their toil or treasure, but as they did in the Dark Ages, they would claim communal rights to share the fruits that flow from the sweat of the worker's brow, the saver's thrift, and the investor's venture.

Whereas the Enlightenment was based on the principle that people owned the fruits of their labor and thrift, America now faces a host of proposals to force the sharing of economic rewards that take us back to the medieval concept of communal property where the powerful few could extort part of the fruits of your labor and capital using the logic that if you own a business, you did not build it.

Thankfully, many of these proposals to overturn the Enlightenment's concepts and benefits of economic freedom would at least employ its democratic process by seeking to change the law. This is the latest struggle in the battle regarding the survival and success of economic freedom and prosperity, and it will be played out in elections over the next decade. But an even greater threat to the Enlightenment's economic foundation today comes from the battle now being waged in stockholder meetings and corporate board rooms across America. Today political activists are pressuring corporations to adopt political, social, and environmental policies that would subvert labor and capital in ways that have been rejected by State legislatures, by Congress, and by the courts.

Past reforms by Congress, the SEC, and the courts, designed to enhance shareholder rights, have unintentionally empowered special interest groups to subvert corporate governance, forcing corporations to deal with political and social problems they were never designed or empowered to deal with. The explosion of index funds, whose managers vote shares they do not own, has dramatically increased the danger posed by political activists not just to American corporate governance but to our prosperity and freedom as well.

As the Chairman pointed out, today index funds control 17.2 percent of all U.S. shares and are the largest shareholder in 40 percent of all U.S. companies. Their future growth seems guaranteed by the tremendous price advantage gained by simply buying a slice of various equity indexes rather than incurring the cost of analyzing each individual investment. But that efficiency in buying a slice of the index is not free. An index fund's profitability is not significantly affected by the performance of any given company in the index since their primary competitors sell the same indices. Therefore, index funds and their proxy advisors have neither the knowledge nor the aligned interest to make informed judgments on business-specific questions that arise in stockholder meetings of companies in which they control an ever-increasing share of stockholder votes.

When index funds vote their investor's shares on broad social and political issues, the problem is not just lack of aligned interest and knowledge; the problem is that index funds have a glaring conflict of interest. On those high-profile issues, the profitability of the scale-driven index fund business will be affected largely by how the public perceives the vote the fund cast and how that vote affects the marketing of the index fund. The index funds' financial interest, therefore, can and often will be in direct conflict with the investor's interest.

As the Chairman pointed out, before his death Jack Bogle, founder of Vanguard, urged legislation to explicitly impose a fiduciary duty on funds "to vote solely in the interest of the fund's stockholder." Anybody voting anybody else's shares or advising on how to vote those shares should be bound by strict fiduciary responsibility. But even enhanced fiduciary responsibility will not solve the inherent conflict of interest that index funds face in voting investor shares on high-profile social and political issues that have a potential impact on the marketability of the very funds that are making the vote or casting the vote. On those issues maybe it is time for the SEC to require that index funds poll their investors and vote their shares only as specifically directed. We cannot allow the economic interest of index funds to effectively convert "private purpose," for-profit C corporations into "public benefit," not-for-profit B corporations which the investors in the general index funds did not invest in.

History teaches us that if we want to be prosperous and free, within the rule of law, we must let private interest create wealth and reap the rewards of its creation. Only after wealth has been created should we debate the cost and benefits of taxing and redistributing it.

Chairman CRAPO. Thank you, Senator Gramm.

Senator BROWN. Mr. Chairman, I ask that the other two witnesses, if they need to take an extra 6 minutes, double their time, that they are able to.

Chairman CRAPO. We will do that, but we like to ask everybody to try to stay to your schedule if you can.

Mr. Copland.

STATEMENT OF JAMES R. COPLAND, SENIOR FELLOW AND DIRECTOR, LEGAL POLICY, MANHATTAN INSTITUTE FOR POLICY RESEARCH

Mr. COPLAND. Chairman Crapo, Ranking Member Brown, Members of the Committee, thank you for the invitation to testify today. This has been a longstanding and significant focus of my research, and what we are talking about today is a bit different from what the Ranking Member was talking about. He was talking about the voices of Main Street investors, but when we look at the market today, 70 percent of all the outstanding shares of publicly traded corporations in the United States are held by intermediaries, institutional investors, and that remaining 30 percent that still holds stocks directly, only 29 percent of them vote their shares in these proxy ballots.

The rise of institutional investing is not surprising. Institutional investors allow the ordinary person, the Main Street investor, to outsource decisions to knowledgeable professionals and to diversify holdings even if they have limited assets. And, similarly, it is not surprising that common stock ownership remains the principal form of ownership of large, complex, profit-making business organizations today. By raising capital with equity rather than debt, entrepreneurs can finance their ventures without placing any obligation to pay funders an immediate or regular cash-flow. So I fully concur with Senator Gramm that our unparalleled economic success is closely linked to precisely these ownership structures.

But the central question before the Committee today involves the intersection of institutional investing and shareholder corporations. Individuals who entrust their assets to corporate managers and individuals who entrust their assets to institutional investors both have some difficulty overseeing the entities that they give their funds. In each case, we see what economists call "agency costs."

The Federal Government has long played a role in overseeing both investment companies and stock exchanges. But institutional investors that dominate voting today have significant agency costs themselves. Institutional investors are monitoring corporate boards and managers, but who is monitoring the monitors?

The rules and regulations of the Securities and Exchange Commission had been enabling special interests to pursue social and policy goals. Under current SEC rules, any shareholder in a publicly traded corporation that has held at least $2,000 in stock for at least a year may place a proposal on the company's proxy ballot. In 2016 and 2017, a majority of shareholder proposals sponsored at Fortune 250 companies involved social or policy issues largely unrelated to share value, executive compensation, or traditional board governance concerns.

In February of this year, jeans maker Levi Strauss filed the paperwork to become a publicly traded corporation. Less than 1 month later, the People for the Ethical Treatment of Animals announced it was acquiring the minimum requisite $2,000 in stock in Levi's in order to propose shareholder resolutions involving the manufacturer's use of leather.

Proxy advisory firms, another intermediary, can serve to amplify this special interest advocacy. As I summarized in a 2018 report that I coauthored with Stanford's David Larcker and Brian Tayan,

a substantial body of empirical evidence shows that proxy advisory firms' recommendations influence institutional investors and corporate managers alike. And at least some proxy advisory advice may not be in the average shareholder's interests.

With trillions of dollars of assets under management, large mutual fund families are less susceptible to capture than proxy advisors. But at least some large diversified mutual funds like BlackRock have also been moving to support some social and environmental causes in discussions with corporate managers. That is partly due to public pressure campaigns, and it is partly due to the fact that portfolio managers tend not to involve themselves heavily in shareholder voting, and instead large institutional investors staff in-house corporate governance teams.

As Senator Gramm alluded to, this is particularly strange in the context of index funds, the premise of which is to leverage capital market efficiency and minimize active management costs, in essence to follow the stock market. But in shareholder voting decisions, such fund families are actively supporting efforts to modify corporate behavior. There is no clear investment-based rationale for this obvious tension and strategy.

In 2015, the Manhattan Institute commissioned an econometric study of shareholder activism and firm value. Tracie Woidtke, a professor at the University of Tennessee, found that "social-issue shareholder-proposal activism appears to be negatively related to firm value."

In conclusion, abetted by SEC rules and procedures, institutional investors have gained power in the boardroom. By coopting proxy advisory firms, and, to some degree, institutional investors, activists have pursued their agendas at other shareholders' expense. At least some of this social activism appears to be depressing share value.

Thank you for your time and consideration.

Chairman CRAPO. Thank you very much.

Mr. Streur.

STATEMENT OF JOHN STREUR, PRESIDENT AND CEO, CALVERT RESEARCH AND MANAGEMENT

Mr. STREUR. Chairman Crapo, Ranking Member Brown, and Members of the Committee, I really appreciate your invitation to testify before you today. Thank you. My name is John Streur. I am president and CEO of Calvert Research and Management. We are a global investment firm. We invest in all developed and emerging markets, equity, and debt. As noted, we are part of Eaton Vance.

Our primary focus at Calvert is to generate competitive investment returns for our clients, and we incorporate information about how company managements are dealing with environmental, social, and governance risks into our investment decisions. We do this because, increasingly, these issues matter to corporate profits.

Today companies and investors throughout the world are working to better understand exactly how to further the tremendous progress that corporations, competition, and capitalism create, as noted by former Senator Gramm, by conducting deeper analysis of environmental and social impacts and of corporate governance systems worldwide. All of us are interested in driving long-term

shareowner value, improving the performance of American companies through a better understanding of these issues.

In recent years, interest in corporate exposure to issues such as energy efficiency, water conservation, workplace diversity, and human rights has intensified. A heightened awareness of these issues among consumers and investors alike has pushed ESG investing well into the mainstream. In 2018, in the United States alone, more than $12 trillion was invested in strategies that consider ESG criteria. Most of these were not index strategies, by the way. This is a 38-percent increase since 2016. The $12 trillion using some form of ESG research represents 26 percent of professionally managed assets in the United States. It was revealed this morning that, globally, $30 trillion are invested using some form of ESG research and analysis.

Investors are not the only ones changing their behavior. Corporations are really leading this and taking action. Many companies in the United States have increased their focus on actively managing and reporting on ESG risks in order to remain competitive in the global market for products and services and capital.

Eight years ago, only 20 percent of the S&P 500 companies provided any type of reporting on relevant ESG risks. Today 90 percent of companies in the S&P 500 actively and voluntarily report on ESG risks factors. So CEOs of companies in the U.S. and throughout the world are on the move dealing with these issues. So the business case for incorporating ESG considerations into the investment process is strong and it is well grounded in empirical evidence.

I want to emphasize the concept of financial materiality. We are not interested in all ESG issues. We are interested in the ones that matter both to the environment and society and to corporate profitability.

Corporate disclosure standards have also evolved over time to reflect changing industry trends as well as regulatory and judicial developments. Undoubtedly, there has been substantial debate and discussion on these issues, probably amongst Members of this Committee. I would like to briefly speak to the issue's relevance as it pertains to the benefits of standardization and the competitiveness of U.S. capital markets.

As you know, in the U.S. we are fortunate to have the deepest, most liquid, most well-developed capital markets in the world. They are also well known for transparency and excellent disclosure. Yet when it comes to the issue of standardizing disclosures related to ESG risk factors, unfortunately the U.S. is beginning to lag behind our foreign competitors. This is an issue that will manifest itself in more difficulty for American companies to access foreign capital going forward.

Much of the information provided through voluntary disclosures is difficult to compare and inconsistent across the issuers of securities, resulting in considerable costs and resource expenditure for investors. While it is impossible to discern the amount of expense incurred by investors attempting to deal with ESG data, one estimate suggests that by 2020, $745 million will be spent annually trying to discern ESG data alone. So we suggest an effort to create standards for U.S. issuers of securities to use. Our concern is that if we

do not do it, foreign regulators will, and they will be in a position to guide what we have to do here in the U.S.

The title of this hearing has to do also with proxy advisory firms, so I would just like to make a few comments in terms of how Calvert uses those firms and introduce a couple of additional concepts in addition to this point about financial materiality.

A core part of Calvert's investment approach is structured engagement, our use of the well-designed feedback mechanism for investors of all types to communicate directly with the management of companies. The proxy voting process is part of our capitalist system. It is an opportunity for shareowners to show their knowledge, give feedback to companies, and attempt to guide those corporations. The vast majority, perhaps all investors, do this in an effort to enhance profitability and drive shareowner returns. All of us have the same financial incentives here.

At Calvert, we do use proxy advisors. There are two large ones in the U.S.: ISS and Glass Lewis. I think it is important for everybody to understand the role they play.

On the one hand, they are an essential part of the infrastructure. The process of voting proxies is transaction intensive and it is laborious. Calvert voted 47,000 issues last year alone across 4,760 annual general meetings. The actual process of that in the U.S. is cumbersome, so these proxy advisory firms serve an essential purpose of helping with the voting, the casting of votes, and the recordkeeping.

Additionally, the number of issues that we have to deal with is vast. These companies provide expert analysis of our proxy voting guidelines and make recommendations to us, but just recommendations. At the end of the day, mutual funds and institutional investors are fiduciaries, and it is our responsibility to make sure these votes are cast in a way that is consistent with our objectives. Our objectives are to drive long-term shareowner value, make no doubt about that.

So the proxy advisory firms fulfill an essential purpose. If there is something to be done here, one might consider a requirement for mutual fund companies and institutional investors to fully disclose their proxy voting guidelines. Many of us do on our websites so all investors can understand our point of view and where we stand on these critical issues.

I would also point out that proxy voting histories are a matter of public record. Investors who care can access that information, and they can understand how their mutual fund or asset manager has voted.

I would like to again thank the Committee for allowing me the opportunity to share my perspectives on these important topics. My sincere hope is that this forum provides an opportunity for constructive dialogue on how to balance the ongoing competitiveness of U.S. capital markets, investment management firms, and corporations with the need to ensure that our capitalist system achieves the most sustainable future possible.

Thank you.

Chairman CRAPO. Thank you, Mr. Streur, and I will start with you in my questions.

I understand your point that, if I understood you right, your focus on ESG risk factors is all ultimately to determine the most profitable position that a corporation can take. Is that correct?

Mr. STREUR. Yes.

Chairman CRAPO. And in terms of your discussion of the use of proxy advisors, I take it that you are comfortable that the proxy advisors you use are helpful to you in that context. Many of us are concerned that, with the concentration of power, of voting power, with those who have proxies, political considerations rather than profitability considerations will start or even have started to rule the day.

Do you have that concern or do you think that is not an issue that we should be worried about?

Mr. STREUR. Thank you, sir. I understand your question. We in the capital markets worry about everything, so I would not discard your concerns outright. But we are all in this investment business extremely competitive, so the market is—we participate in the free market system. It has a way of governing itself. I do not think you need to worry that any of us are going to put political considerations in front of profitability or in front of our track records. I do not think that concern is well founded at all. I am sorry.

Chairman CRAPO. All right. And can I ask Senator Gramm and Mr. Copland to respond to that same issue?

Mr. GRAMM. Well, let me say that my dealings with proxy advisors basically have been good. I think they listen. I think it is somewhat concerning there are only two firms, and one of those firms is very much affiliated with an interest that has a political position. But I think the problem is not proxy advisors. I think the problem is that whenever you have somebody voting somebody else's shares and it is not their money, you have a potential problem. It is just like when somebody is spending somebody else's money, you have a potential problem, even when those are good people.

And so I think the big, big problem is that we are headed like a freight train toward a situation where corporate America, the engine of much of our economic progress and mass production, is going to be controlled by index funds that do not own shares directly in those companies but are voting somebody else's shares; and when they are voting those shares, on high-profile issues like environmental issues, like social issues, like political issues, they clearly are aware, have to be aware that the performance of the stock that is affected by their vote is not going to affect their ability to sell their index because their competitor is selling the same index. But how they vote and the publicity it gets is bound to affect their marketing. And so you have got a conflict of interest building between the interests of the shareholder and the index fund, and the index funds are becoming more and more dominant, even in small companies.

And so wherever you are on the political spectrum, this is something I think we ought to be concerned about.

Chairman CRAPO. Thank you. And, Mr. Copland, you have got my last 50 seconds.

Mr. COPLAND. Sure, Mr. Chairman. I agree with everything the Senator just said. I want to add a few pieces of information to that.

The proxy advisors do often run out in front of the institutional investors on these issues, and I show that in my written testimony. I have written about that. They get ahead in terms—they are much more likely than the median shareholder to support these social and environmental proposals for various reasons. And they do influence voting. Fifteen percentage points is what we did in our econometric analysis. There are a lot more in that study I did with Larcker and Tayan. We have seen politics come into play, express partisan politics. I am sure the Ranking Member likes it that we see companies get more targeted by labor union pension funds when they give more money through their PACs to Republicans. But that is a little troubling if they are actually fiduciaries there.

Chairman CRAPO. Thank you.

Senator Brown.

Senator BROWN. I am not sure your assessment of my opinion is well founded, but since we know each other so well, feel free to make it.

Mr. Streur, I think we should do more for workers than just new disclosures, but if a company describes how it is managing its workforce or investing in worker training and skills, what does that tell investors about the long-term value and sustainability of a company?

Mr. STREUR. Well, today the way companies create well-being for their workforce is a big determinant of their return on invested capital and their profitability. So investors are very, very interested in understanding how companies create well-being for a diverse workforce, and it tells us whether or not management is expert at creating a workforce that can be globally competitive for the long term.

Senator BROWN. So that is not politics. That is good business.

Mr. STREUR. Totally good business. That is all we are interested in, really.

Senator BROWN. OK. This question is for all three witnesses. I will start with Mr. Gramm, and I would like an answer as close to yes or no as you can possibly give. Should shareholders be able to hold executives and directors of opioid manufacturers and distributors accountable for misleading the public about how addictive these drugs are?

Mr. GRAMM. I think anybody who misleads the public should be held accountable.

Senator BROWN. OK. Mr. Copland.

Mr. COPLAND. Assuming, arguendo, that, in fact, there was a fraud, then there is and could be accountability, sure.

Senator BROWN. OK.

Mr. STREUR. Absolutely.

Senator BROWN. Should large and small shareholders have a right to question a company's policies if they create financial or reputational risk for the company? Mr. Gramm.

Mr. GRAMM. Small and large stockholders should always have the right to question a company. That is what a corporate structure is about.

Senator BROWN. OK. Mr. Copland.

Mr. COPLAND. It depends what you mean by "question," and that is really what we are talking about, is how do we allocate the pow-

ers. Should a small shareholder be able to impose massive costs on all the other shareholders through processes affirmed by the SEC? Probably not.

Remember that when we are talking about publicly traded corporations, every shareholder has the right to exit. So if they are really concerned about a company, they can sell their shares.

Senator BROWN. Mr. Streur.

Mr. STREUR. Here in America the answer is yes, small and large shareowners should have rights to question management and make a contribution.

Senator BROWN. Regardless of Mr. Copland's qualifying statement?

Mr. STREUR. Yes, regardless of that.

Senator BROWN. OK. Mr. Copland, what do you think about that?

Mr. COPLAND. I think he is probably wrong. If they were forced to internalize their costs, Roberta Romano at Yale Law School, for instance, suggested a loser-pays type of mechanism where if a shareholder proposal is introduced and is defeated by a majority of shareholders, then that sponsoring shareholder has to reimburse the cost. That sort of idea might make it more tenable. But, otherwise, you have things like what I have described where the People for the Ethical Treatment of animals buying 2,000 shares of stock and generating many multiples of that of cost on the company to try to hijack the proxy process to make their political statement.

Now, the political statement might be right, but that is not what the proxy process should be about.

Senator BROWN. Well, you and before, Mr. Streur, since you have assumed you know how I think, I guess I will assume with your Manhattan affiliation how you think, that that whole loser-pays ideas you all find really attractive, I am sure. Mr. Streur.

Mr. STREUR. Well, that is a regressive tax concept if we are going to talk that small shareowners bear those costs. It is not what our free market system is all about. We have already regulatory processes in place at the SEC that create a set of requirements for what the shareowner can actually get on the ballot. Those have been adequate. They continue to be adequate. So we have got a good process in place already, and the concept of boxing out the little guy is not what our free markets are all about. It is not what American capitalism is all about. So these costs are theoretical. We have got a system in place that deals with those. And we are not interested in creating a super class of investors in this country. We are interested in equality and supporting the ability for small investors to have their voices heard. That is how the system has been designed, free market.

Senator BROWN. Let me ask one last question——

Mr. GRAMM. Senator, could I respond to that question as well?

Senator BROWN. Sure.

Mr. GRAMM. I think the plain truth is that all over America this process is being abused. People are buying a small number of token shares to force corporate board meetings to deal with issues that have nothing to do with the company, and they are using up valuable time, and they often end up being bought off. So I think to suggest that there is nothing wrong with the system is absurd unless your objective is to see the corporate system literally tied up

in knots for no productive purpose. But its purpose is to create the prosperity that we enjoy.

Senator BROWN. Well, and we have seen no corporate misbehavior and nothing else seems to be——

Mr. GRAMM. Well, look, the fact that corporations misbehave does not mean——

Senator BROWN. ——the White House regulators do not keep them——

Mr. GRAMM. ——the system is not abused.

Senator BROWN. ——hold them responsible and accountable. So I tend to come down on the side of the shareholders.

Mr. Chairman, thank you.

Chairman CRAPO. Senator Rounds.

Senator ROUNDS. Thank you, Mr. Chairman.

I had a kind of sequence here that I wanted to go through, but, Senator Gramm, I think you have hit on something that I wanted to explore later on, but I think I am going to go right to it. And this would be for all of our participating members here today.

Mr. Copland, in your testimony you noted the great extent to which retail investors are able to play a part in the shareholder proposal process. In particular, you cited examples of which investors who held barely a few dozen shares of stock representing less than one ten-thousandth of 1 percent of an entire company were able to place proposals on annual shareholder ballots. Senator Gramm, you are alluding to a similar position. This is due largely in part to an SEC regulations that allows any shareholder in a publicly traded corporation that has held at least $2,000 in stock for 1 year to place a proposal on that company's proxy ballot.

Is this low threshold a good idea or is this something that the SEC needs to revisit? And, Mr. Copland, if your comment is within the original——

Mr. COPLAND. I have been on the record suggesting that it is too low. It has not been revised in 20 years. I have written on this publicly. If we are not going to do a loser-pays type of mechanism, we at least ought to require an investment sufficiently large so that the investor does not have less than the actual cost. Just the cost of adding this to the proxy ballot alone—and the SEC has done these studies. They are not just theoretical costs, like Mr. Streur talked about.

Now, the big costs are what Senator Gramm was talking about. Taking the time of the board of directors and the CEO of a large multinational corporation to consider these questions, that is the big cost. But the direct costs themselves are less than this.

Is it really squeezing out small investors? I understand the argument, but that is not what is going on. What is happening, as I say in my written testimony, is that you have three individuals and their family members. Who are the individual investors who are active in this process? Three individuals and their family members sponsored between 25 percent and 45 percent of all shareholder proposals over the last several years. So these corporate gadflies are repeat players in this game, and they are doing it over and over and over, and they are getting treated like royalty by CEOs.

Senator ROUNDS. I think, if I could, and I am going to run out of time, but I think your answer is yes.

Mr. COPLAND. The answer is absolutely yes.

Senator ROUNDS. OK. Mr. Gramm, I am going to finish with you, but I want to go to Mr. Streur for just a minute here, and I would like your thoughts. You have heard the discussion, and I think Mr. Copland makes a good point, that there is something involved, but I suspect that you may not agree with him.

Mr. STREUR. Well, I think he does make a good point. There are exceptions to the rule. He is referencing a number of shareholder proposals that have been filed by just a few people. That is not a reason to change a system.

Senator ROUNDS. You are suggesting that the SEC rule by itself is appropriate at a $2,000 level of investment?

Mr. STREUR. Sure. There are specific requirements in terms of how you—you cannot just lob a proposal onto a ballot. There is a process that you have to go through with the Commission. The company has an opportunity to challenge you through the SEC. And only if you meet certain conditions will your proposal actually make it onto a ballot. It is important for us to all understand.

Senator ROUNDS. Thank you. That is what I was curious about, that thought process, that there is a process in place to sort of weed out some would be your position on it.

Mr. STREUR. There is, but I would not discard the concept that there are a few players who file shareowner resolutions that we are not interested in. They do not pass the test of financial materiality. That does not have anything to do with the size of the investor.

Senator ROUNDS. Right.

Mr. STREUR. So we can always improve systems, but the radical change that is being put forward here is not what we need.

Senator ROUNDS. Thank you.

Senator Gramm.

Mr. GRAMM. Well, I think the system is being abused. I think that it is logical that either you should require greater ownership, but I think an even better way would be to simply require that in order to get a vote, you have a certain percentage of the stock owners that support your amendment. You cannot get a vote in the greatest deliberative body in the history of the world, the U.S. Senate, without a second. So why should you be able to stand up at a General Motors stockholder meeting and demand votes on trivial issues based on $2,000 worth of General Motors shares? This just makes no sense. And what is really happening here is two things: one, the seeking of publicity; and the other, the effort to intimidate the company—to intimidate the company to support your foundation or to intimidate the company to negotiate some settlement with you to simply go away. You do not even have a higher threshold to offer the amendment the second time. So if I offer an amendment and I am the only shareholder who votes for it, the next year I am going to offer it again. I mean, clearly this does not make any sense, and it ought to be fixed.

Senator ROUNDS. Thank you, Senator. My time has expired.

Mr. Chairman, I would just make a note that this Committee has in the past looked at ways in which to literally do a number of things that are of social value, and one of them—and I think that we should not miss—in S. 2155 this Committee did work very hard at protecting our veterans, and particularly with—there was a com-

ment made earlier that we did not take care of even our veterans, and yet this Committee in S. 2155 specifically put in language to protect our veterans from financial ruin due to health care issues and medical bills. But thank you, Mr. Chairman.

Senator TOOMEY [presiding]. Thank you, Senator Rounds.

Senator Schatz.

Senator SCHATZ. Thank you, Mr. Chairman. Thanks to the testifiers.

Mr. Streur, I have about eight questions for you, so as close as you can get to yes or no or a brief answer, that would be great. Is ESG mainstream at this point?

Mr. STREUR. Yes.

Senator SCHATZ. Do firms that have high scores in ESG perform well compared to firms that do not?

Mr. STREUR. High scores on financially material issues, yes.

Senator SCHATZ. And what priority does Calvert place on investment performance?

Mr. STREUR. Top.

Senator SCHATZ. And how does ESG investing help you to meet your benchmarks?

Mr. STREUR. It helps us better understand how good management is.

Senator SCHATZ. And so it is fair to say this is consistent with your fiduciary responsibility?

Mr. STREUR. Yes.

Senator SCHATZ. What information is useful to analysts and portfolio managers at Calvert as they make investment decisions? And how available is that information across companies and industries?

Mr. STREUR. That is not a yes–no answer.

Senator SCHATZ. Yes, I understand. You have been quick, so I——

Mr. STREUR. So what is important to understand is that the things that matter to a company are very specific to the business characteristics. So the things that matter to a utility company are different from the things that matter to a software company. So your question about what matters, well, it is very important to understand the specific business that you are analyzing, so different things matter.

Your question about how available is it, it is most available on the largest companies, but it is not completely available through the regulatory filings in the U.S. at all. So there are various initiatives to help companies understand what investors are really interested in and help those companies to create disclosure standards to provide the information that shareowners want.

Senator SCHATZ. And as an example, Senator Gramm referred to ends that are political in nature, and I had to lean back to my staff to confirm that I think what is being talked about is climate disclosure, and I would like to ask you whether you think companies are doing an adequate job of disclosing material climate risk?

Mr. STREUR. It is changing, but we are not close to being there yet. And I think that companies themselves understand these risks fairly well because we can see companies taking action to protect themselves from risks associated with climate change. As investors,

we want to understand how well those managers are doing in terms of allocating shareowner resources for this purpose.

Senator SCHATZ. Right, and your anchoring what you do in materiality I think is a principled and practical way to move forward so that we remove the politics from it. I mean, to the extent that we talk about material climate risks, it ought to be hard-nosed and related to shareholder value. And the difficulty—I think there are numerous difficulties here. One is just that the Securities and Exchange Commission is not accustomed to doing this. The other is that the window for consideration as it relates to climate used to be 10, 20 years, and they could credibly say this is outside of our window. But what has happened is that, whether it is the Quadrennial Defense Review or any other Government analysis of climate risk, it is now within the window that ought to be under the Securities and Exchange Commission disclosure. So I thank you for all the work you have done.

I have a question for Mr. Copland, and I want to flesh out the sort of social-political goal thing. After the Enron scandal, the number of corporate governance-related shareholder proposals exploded. This is the "G" in ESG, right? And when U.S. companies divested from South African companies during apartheid, mostly as a result of shareholder resolutions calling for divestment, they applied pressure and made change. And I am assuming you think those were appropriate uses of shareholder activism. I mean, I am trying to figure out where the line is or whether it actually—your judgment ends up being made on the basis of what you think is so much a political consensus that it is no longer political. In other words, I assume that you think it is OK for a publicly traded company and shareholders to say, hey, we do not want to be discriminating against LGBTQ; we do not want to be investing in companies that do, you know, wrongful actions but not illegal actions overseas. There is reputational risk there. Apartheid is a good example.

Climate is not ripe politically in your mind, but what is the difference in terms of the law?

Mr. COPLAND. Well, the difference in terms of the law has shifted over the years, and it is really not law. It is really SEC rulemaking. But I think what you were getting on at the beginning—and I do not agree with all the things you are talking about that they should be part of the shareholder proposal process. What you were getting on at the beginning I think is an important distinction. ESG is this sort of merged term, but governance issues are different from environmental and social issues.

Senator SCHATZ. OK. What about the apartheid example? Do you think that is an appropriate use of shareholder activism?

Mr. COPLAND. No, I do not. I think it should be excluded from the ballot. The SEC used to have a rule that issues of general social-political concern were excludable from the ballot. This was the rule from the early years through the 1970s. And then there was litigation that went to the D.C. Circuit involving the use of napalm in the Vietnam War, with the underlying against Dow, and the D.C. Circuit sent it back to the SEC, and the SEC changed the rule. They were not ordered to change the rule. They changed their rule, and since then now this is the window through which all these social and political issues have come into play.

But, no, I think that is a board of directors decision. Those are the fiduciaries who are running the company. I totally agree that the boards should be——

Senator SCHATZ. You do not think there is——

Mr. COPLAND. ——sensitive to the issue.

Senator SCHATZ. Hold on. Let me just get one last question in. You do not think there is—in the case of apartheid, you do not think there is reputational risk that would impact profitability?

Mr. COPLAND. No, no, no. That is not what I said. Absolutely there is reputational risk. The question is who decides. Where does the decision lie? Does it lie with the shareholders or the directors?

Senator SCHATZ. Hold on. The decision, of course, is the board of directors. The question is whether an individual shareholder has the authority to present something to the board of directors for decision making. Now I get that there are individual gadflies that are doing what they are doing, but the basic question of whether a shareholder is a shareholder is a shareholder or does it depend how much wealth you possess? Does it depend on the extent to which you are a shareholder? If you have $2 million, do you have certain rights that a $2,000 shareholder does not have? And there is just no evidence that we should move in that direction.

I have exceeded my time. Thank you.

Senator TOOMEY. Thank you.

Senator Tillis.

Senator TILLIS. Senator Gramm, finish the thought you had.

Mr. GRAMM. Well, what would you think if the resolution demanded the company not do business in Israel?

Senator TILLIS. I think that pretty much sums that one up. Now I have a question——

Mr. GRAMM. The problem is if you start down that——

Senator BROWN. Wait a second. Wait, wait. Senator Gramm, wait a minute. Mr. Schatz did not respond because it is not his time because Senator Gramm—actually, Mr. Gramm—I will call him "Mr. Gramm"—is not actually Chairman of this Committee now. So if you want to yield time, but do not make a point that he wins, he loses—he did not speak.

Senator TOOMEY. So will Senator Tillis yield time to Senator Schatz to respond?

Senator TILLIS. My time?

Senator TOOMEY. Yes.

Senator TILLIS. No.

[Laughter.]

Senator TOOMEY. OK. The time is yours.

Senator TILLIS. I could yield your time, but not my time.

Mr. GRAMM. Could I finish the question?

Senator TILLIS. Yes, Senator Gramm.

Mr. GRAMM. The problem is if you start down this road, there are all things that we think are bad. I do not know anybody that does not think apartheid——

Senator TILLIS. Well, Senator Gramm, that—because I want to ask——

Mr. GRAMM. The problem is you get into other things.

Senator TILLIS. That is exactly the point. That is why we do sanctions. That is why we exist to take care of those things and not necessarily put it on the backs of value creators.

The question I had for you, my lane back when I was in the private sector was in supply chain and supply chain optimization, and if you look at FTSE and they rate General Motors and Exxon as having pretty solid supply chains and well-run organizations. An alternative index for FTSE, though, rates Tesla higher because of green output. The concern I have about—Tesla is awesome, love the car, would like to afford one someday. They have got a great car. They have got a very, very disturbing supply chain. You see it in the number of products they bring to market, how long it takes to fix a car when it gets damaged. They have got a lot of fundamental problems as a manufacturer that they need to take care of. But the investor would look at that and say, well, this is probably a pretty good investment, pretty good buy. How do you feel about that, rating a company based on output versus their ability to sustainably produce that output?

Mr. GRAMM. I think that investors will make good decisions if you give them information. I am very much opposed to forcing companies to do things as part of some social objective. The problem is all of these—the crisis we had in the housing industry was a result of trying to force private money to serve public purpose. Congress made Freddie and Fannie meet quotas on subprime lending. They forced them to destroy the standards for making loans. CRA forced banks to make subprime loans. And what was the result of all that, making private wealth serve public interest? We call it the "financial crisis."

So it is just a bad way. I think you said it well, Senator. Congress is supposed to make these decisions. Who licensed General Motors to set public policy? Their duty is to build good cars and to do it efficiently and to create profits for the people who invest in the company and a good place to work for the people that work for the company.

Senator TILLIS. By the way, I do not think your point about Israel is far off. We know all about BSD——

Mr. GRAMM. No, it is not far off.

Senator TILLIS. ——activist groups out there that are trying to advance those sorts of things through the corporate board. So I think it is actually a very good point.

I do have a question about ESG in Europe. You know, Europe does not have the thriving capital markets liquidity that we enjoy here. Do you think maybe their interest in this approach is it drives our performance down? Or is there some other motivation that you could see other than that? They are never going to rise to our level of execution, so what is their end game to actually shift the social responsibility to corporations? Mr. Copland.

Mr. COPLAND. I think there is definitely a push afoot in that. A year ago, in April, I was in Paris talking to some of the international bodies there at the invitation of the Administration, and France was considering precisely this, a move toward a more stakeholder model of capitalism. Your colleague on the Committee, Senator Warren, has proposed a bill and wrote in the *Wall Street Journal* going in that direction. I think it is precisely the wrong direc-

tion for the reasons I write about at length, including in my written testimony. But, yes, there is an effort afoot on that.

And I do think that that is distinct, I want to emphasize, from what Mr. Streur was talking about, where if we can agree on materiality, financial materiality, we are pretty close together on that.

Senator TILLIS. My time is up, but, Mr. Streur, I want to tell you I appreciated your thoughtful comments and your testimony. And I think you are going about this in a reasonable way. It is not on or off. I just feel like we are going down a path that will really disincentivize innovation and global competition, which I am very, very concerned with.

Thank you, Mr. Chair.

Senator TOOMEY. I want to thank all the witnesses. I want to start with an observation of my own. It has long seemed to me that one of the crown jewels of the greatest free enterprise economy in the history of the world has been our capital markets, big and broad and liquid, and increasingly in recent decades democratized in a way that did not look plausible decades ago. Index funds, low-cost even free equity trading for retail investors, retirement plans, these have come together to create investment opportunities for people of modest means that never occurred before.

What I am worried about is a trend that we are on now most recently. Since 1997, the number of public companies has been cut in half. One of the real-world consequences to the delays of private companies going public is the small investor never gets a chance for the huge upside that often comes in high-growth companies.

This is, I think, a huge problem. I think the ESG activism is contributing to companies choosing to stay private longer than they otherwise would, and that is depriving retail investors. And I think we have got an obvious need for reform in three areas.

One, I think shareholder proposals, the threshold for introducing them are clearly too low because people who have no real financial interest in the company are nevertheless able to tie up huge amounts of resources on behalf of that company.

I think proxy advisors, there is a real question of whether they are aligned with the interests of investors, and there are obvious conflicts of interest. I think we need a new rulemaking to deal with that.

And, finally, institutional investors, mutual funds, and pension funds, there needs to be a clear and unequivocal explication requirement that they have a duty to maximize the return to investors. That is their job. They are fiduciaries.

So I am urging the SEC to take all three of these steps as quickly as they can, and certainly in time for these new rules to be in effect for the next proxy season.

I want to go back to this question about shareholder proposals. Mr. Copland, in your testimony you highlighted an amazing case where a group that owned 47 shares—not 47,000 shares—47 shares of McDonald's out of the 765 million shares outstanding could nevertheless force a question. This would be numerically equivalent to 20 Americans out of the 320 million Americans, for 20 Americans to force a national referendum on all of us. It seems to me that it is reasonable to require a broader interest in an issue before it can be brought. Do you have a specific change to the

threshold in mind? Do you have a specific reform that you would recommend?

Mr. COPLAND. I have talked about it before, and, you know, the House had some legislation on this. I actually thought that the percentage ownership—they did it as more a percentage ownership, and there is a percentage in the rule. It is just irrelevant because the dollars are so low. They had 1 percent, which I think is too high, probably, especially for large cap companies. But certainly a material percentage would be one mechanism. The other would be a loser-pays type of mechanism.

Senator TOOMEY. And just to be clear, if you establish some threshold—let us call it 1 percent—that does not mean that the only person who would be able to drive an issue would be someone who owns that much but, rather, someone who could cobble together other investors who shared the interest.

Mr. COPLAND. You could aggregate shares, and you do see regularly social investing funds, public pension funds, et cetera, coming together on some of these issues.

Senator TOOMEY. So, Senator Gramm, is it your view that the increasing levels of social-issue shareholder activism does, in fact, discourage some companies from going public? Does it delay that?

Mr. GRAMM. I think there is no question about that. I think what is happening is that special interests are trying to force American business to implement policies that you are rejecting in the U.S. Senate. We have got special interests that are trying to force business—banks not to make loans to specific kind of businesses. I do not understand why people do not see how dangerous that is, because you can start with no loans to consumer lenders or no loans to gun dealers, and pretty soon you have got a policy where you are cutting off sectors of society from getting access to private services. This is a very dangerous business. Congress ought to be making those decisions.

Senator TOOMEY. And if it is true that companies are delaying going public out of this very concern, does that not have the effect of depriving retail investors, people of modest means, the opportunity to invest in companies that could generate terrific returns for them?

Mr. GRAMM. It is clear that it is discouraging companies from going public. It is clear that these kind of concerns that are imposed are like leeches that are leaching away the productive capacity of not just capital but labor. And I think we have got to be very careful that we do not let special interests try to win in the corporate boardroom battles they cannot win in Congress, cannot win in the legislatures, cannot win in the courts.

Senator TOOMEY. Thank you. My time has expired. I think the Ranking Member has a quick follow-up question he wanted to ask.

Senator BROWN. Thank you, Senator Toomey.

I have one follow-up question, Mr. Copland. Talking about one of the McDonald's shareholder issues, there was a small shareholder that in 2017 had a proposal about McDonald's use of antibiotics. The next year, McDonald's announced it would reduce its use of antibiotics, citing threats to global health and food security. Doesn't that shareholder proposal, even though offered by a shareholder with small holdings, doesn't that seem like an important issue to

the company? And then didn't that result in something even though it was a small—it was a modest shareholder?

Mr. COPLAND. My argument is not at all that companies are nonresponsive to shareholder proposals. Quite the contrary. And my argument is not that every shareholder proposal is a bad idea. Quite the contrary. Some of them are good ideas.

The question is the process. The process matters because, otherwise, you are enabling individuals to just sort of seize this process. There is no question that antibiotics at McDonald's is not something that they would never have thought about if the Benedictine Sisters of Boerne, Texas, had not bought 52 shares in McDonald's and introduced that shareholder proposal. I will guarantee you the managers at McDonald's and the executives and the board is thinking about those sorts of issues. The question is whether that small group of nuns should be able to make this a boardroom discussion and an annual meeting subject on the proxy ballot that the SEC oversees.

Senator BROWN. Mr. Streur, would you comment on that?

Mr. STREUR. Well, I think, by the way, you are right. McDonald's and many other food companies have figured out that the American consumer does not want to eat food from animals that have been doused with antibiotics for lots of reasons. And then this concept that the shareholder proposal in and of itself forces companies to do something is deeply flawed. The shareholder proposal puts it to a vote, the American system. The shareholder proposal gets it on the ballot so we can see what other shareholders think. Then you get a vote, and you can say, "Hey, this small group in Texas of nuns has an issue. Put it on the ballot. Let us see what everybody thinks." Wow, 24, 25, 30, 35, maybe even a majority votes in favor of it. That is how the system works. So it is a good——

Senator BROWN. You suggest that even if it does not carry a majority of shareholders, but if it has 15 or 20 or 30 or 35 percent minority vote, it makes the board think a little more seriously, particularly in a consumer company, about its behavior?

Mr. STREUR. Sure. And, by the way, there was a lot of discussion about how index funds vote. Index funds vote mostly with management. Predominantly, they just throw the lever and vote with management. That has been the history. So when you get a 25-percent vote of shareowners knowing how much is held by index funds and their habit of just supporting management, it is an important feedback mechanism for that board and that management. If nobody voted for it, it goes away. You cannot come back the next year if nobody voted for your proposal. You have got to get a certain percentage to come back on the——

Senator BROWN. If I had sat here through this Committee, from what you said about index funds just then, and listened to your two colleagues, I would have thought index funds had a much more insidious, pernicious influence and almost never voted with management. It is interesting you say that.

Senator TOOMEY. So this has amounted to a second round here, so I am going to ask——

Senator BROWN. Senator Van Hollen has not had a first round.

Senator TOOMEY. So we usually alternate. I think that is the tradition of the Committee. So I would like to pose a question to Mr. Copland, and then we will go to Senator Van Hollen.

There is a report that I think you referenced in your testimony by Tracie Woidtke—I may be mispronouncing her name—about public pension fund activism and firm value. And my understanding from the executive summary is the conclusion includes that ownership by public pension funds engaged in social-issue shareholder-proposal activism is negatively related to firm value, according to this study. And, specifically, then ownership by the New York State Common Retirement system is also negatively related to firm value during the period in which the fund was actively engaged in sponsoring shareholder proposals related to social issues.

So I guess the question is: From your research, does it appear that this kind of activism is actually harmful to investor interests?

Mr. COPLAND. From the research we have done, the short answer is yes, and we commissioned that study precisely because we wanted to ask the question when we saw what was going on, because these public pension funds are quite different from what Mr. Streur—Mr. Streur is absolutely—he is running Calvert. He has got to hold onto his assets. If he does not get good returns, people are going to leave his fund and go somewhere else with their money.

That is not the case for our public pension funds that exist for the retirement of our public employees. These are run by boards, but they have got the capital locked in. And in the case of something like the New York State Common Retirement Fund, the sole fiduciary is a partisan elected official. So you have got Tom DiNapoli there who is the State comptroller of New York, the sole fiduciary of the fund—had no investment background, by the way, when he got that job. And that fund has repeatedly introduced social proposals to try to influence corporate behavior. And what Tracie Woidtke, Professor Woidtke, discovered in her study—and this was building on a methodology she had done in her doctoral dissertation—is that this is actually negatively related with firm value.

I also just want to clarify that what Mr. Streur was talking about, about, well, you have got to get some support to get back on the ballot the next year, that is true. But under the SEC rules, you need 3 percent of the vote. So if 97 percent of the shareholders vote no but 3 percent vote yes, then the shareholder proponent can get the same proposal on the ballot the very next year. One thing we have argued is that seems really low and probably should be raised.

Senator TOOMEY. Thank you.

Senator Van Hollen.

Senator VAN HOLLEN. Thank you, Mr. Chairman, Ranking Member. Thank you for your testimony.

Senator, I was glad to hear you start out talking about the Enlightenment and individual rights, and as I listened to this hearing—and I had to step out for a moment—it seems to me that you are actually advocating a position that is the opposite of allowing people to make their individual choices with respect to these deci-

sions. The gentleman, Mr. Streur, saying that you are going to try and restrict proxy advisors or put rules on proxy advisors——

Mr. GRAMM. I did not mention proxy advisors——

Senator VAN HOLLEN. No? OK. Well, and institutional investors.

Mr. GRAMM. Well, let me say——

Senator VAN HOLLEN. No, no. I have got my 5 minutes, and I am going to ask my question.

Mr. GRAMM. Well, OK.

Senator VAN HOLLEN. But what it seems to me—because we have had a lot of testimony. This hearing has been a lot about proxy advisors and institutional investors.

Mr. GRAMM. Not my——

Senator VAN HOLLEN. Well, then, Senator, you will agree with me—right?—that anyone has a right to choose a proxy advisor to look into whatever they want, right?

Mr. GRAMM. If it is their money, they are paying for it——

Senator VAN HOLLEN. Their money. Exactly.

Mr. GRAMM. ——they have a right to do it.

Senator VAN HOLLEN. Because there are a lot of folks around——

Mr. GRAMM. You do not have the right to make them do it, no.

Senator VAN HOLLEN. No, but, Mr. Copland, you agree, right? If I want to hire a proxy advisor, that is my right to do it, and you know what? If I pick a person who makes the wrong——

Mr. COPLAND. Absolutely. I am not arguing for the elimination of proxy advisors.

Senator VAN HOLLEN. OK. But as I listened to the testimony, the suggestion is here they are leading everybody astray, and I would just ask—because I also represent—you know, T. Rowe Price has a big office in Baltimore. You know, they want to hire a proxy advisor; they have been pretty happy with their proxy advisor. As Mr. Streur said, you know, they take into account some of the information. They sift through it. They point out in a letter to me that both ISS and Glass Lewis have transparent mechanisms in place for issuers to address factual errors in their data analysis. And then they go on to say, "We are more concerned, frankly, with the potential"—and this is House legislation from last year—"the potential to undermine and inappropriately influence the independence of proxy advisors."

Mr. Streur, if you could just talk about this a little bit, because I find, you know, the world has sort of turned here. We have had a lot of people—and I do not want to speak again for these gentlemen, but we had a lot of testimony, as I heard some of the testimony, it was like we do not want, you know, individuals to be able to—we want to protect them from themselves when it comes to their ability to go out and say, "I want this institution to vote my stock in a certain way," or, "I want these proxy advisors to provide me information." Could you talk a little bit about that?

Mr. STREUR. Thank you, Senator Van Hollen. Proxy advisors. I first want to point out that many of the examples of proxy issues that we have heard today are at the extreme, things that do have to do with unusual issues filed by very small shareowners. The bulk of the activity is around executive compensation, corporate governance, matters that are extremely important to the competitiveness of American companies. These issues are complex, and we

need to be able to compare one company's executive compensation program to peer groups and get into details in order to properly evaluate resolutions from management or from other shareowners. Proxy advisory services fulfill an extremely important part of that system in terms of aggregating data and information and helping us to understand best practices sector by sector, industry by industry.

So the reality of proxy voting is that the interesting issues that we have been talking about today, while they are important, are the vast minority of what we actually deal with across the thousands of issues that we face every single year. So the proxy advisory system, extremely important, useful. At the end of the day, the fund manager is a fiduciary. They are responsible for the vote. They make the decision. That is our case. That is T. Rowe's case. That is everybody's case.

Senator VAN HOLLEN. Could you also just briefly talk a little bit about the link and correlation between investment returns and the issue of asking for the ESG standards that you and your firm—could you talk about that?

Mr. STREUR. Yeah, thank you. And I think, again, what is important to focus in on is this concept of financial materiality. And I think this gets to the heart of American competitiveness. And a question was asked earlier about what are the Europeans up to. The Europeans are attempting to strengthen their system, to strengthen their companies to be more competitive with Americans, and to attract foreign capital. So when we think about ESG information, what we want is the information that pertains to the profitability, the long-term value of the companies we are analyzing. There is a very, very strong linkage there. And regarding this research about proxy issues, if you focus in on proxy issues that are filed on financially material issues, you get an entirely different result. You find that proxy issues associated with financial materiality are associated with superior investment performance. This is very important for the Committee to understand. We want to strengthen the system. We want to make American companies competitive in an increasingly competitive market. The Chinese are coming. They want foreign capital. We have to keep our companies up to date, so the linkage between financially material ESG performance, profitability, and stock prices is strong. It has been documented by thousands of studies. That is what we want. We want better disclosure, easier to use, on issues that will help us improve corporate America.

Senator VAN HOLLEN. Thank you.

Senator TOOMEY. And I think we are out of time here. I want to thank all of our witnesses for being here today and providing testimony.

For Senators who wish to submit questions for the record, those questions are due on Tuesday, April 9th. I encourage the witnesses, if you receive questions, to please respond promptly.

And with that, this hearing is adjourned.

[Whereupon, at 11:25 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN MIKE CRAPO

Today's hearing will focus on the role of asset managers, proxy advisers, and retail investors in engaging with companies on environmental, social, and governance issues.

Last year, Chairman Clayton expressed concerns that the "voices of long-term retail investors may be underrepresented or selectively represented in corporate governance."

Regardless of the tools that retail investors choose for investing their hard-earned money, it is critical that they have a voice in the investment decisions that are being made.

Whether it is a company's use of a proxy advisory firm or an asset manager's investment decision-making policy, the retail investor should have a clear understanding of the decisions that are being made which ultimately represent their shares.

Last year, John Bogle, the creator of the index fund, wrote an op-ed in the *WSJ* about how successful the index fund has been for investors, noting that if historical trends continue, a handful of institutional investors will one day hold voting control of virtually every large U.S. corporation.

Even at existing levels, as consumers continue to use index funds, there has been an evolution in the concentration of control now held by a small group of asset managers voting a huge number of shares.

Today, index funds hold 17.2 percent of all U.S. shares and are the largest shareholder in 40 percent of all U.S. companies.

With the exception of socially responsible funds, most funds are not targeted at specific environmental or social impact objectives, and many investors in these funds do not expect asset managers to engage companies on social and environmental issues on their behalf.

However, since the 2014 proxy season, institutional shareholders support for inclusion of environmental and social proposals has increased from 19 to 29 percent while retail shareholder support has increased marginally to only 16 percent.

In the 2018 proxy season, ESG proposals were the largest category of shareholder proposals on proxy ballots with 15 percent of proposals climate-related and 14 percent related to political contributions.

It is important to understand how institutional investors are voting the shares of the money they manage to make sure that retail investors' interests are being reflected in these voting decisions.

Today, I look forward to hearing from our witnesses on the following questions: How are the retail investors being engaged within the proxy voting process and in setting the policies used by the asset managers of the passive funds with which they invest? Are these shares being voted to drive productivity in our economy and increase investors' return on their hard-earned investments, or are intermediaries using other people's money unbeknownst to them in order to advance environmental, social and other political policies? What financial and other criteria are used in identifying social issues for engagement and measuring engagement success for end-investors?

I look forward to hearing the views of our witnesses on these issues, and I thank them for their willingness to appear today.

PREPARED STATEMENT OF SENATOR SHERROD BROWN

Thank you Chairman Crapo and welcome to our witnesses.

I hope today's hearing will allow the Committee to better understand the growth of environmental, social, and governance, or ESG, investing principles.

Corporations have become beholden to quarterly earnings reports. One survey of financial executives from public companies found that 78 percent would sacrifice economic value of their own company just to meet financial reporting targets.

That's no way to grow our economy.

Families don't think in terms of 3-month earnings quarters—they think in terms of school years, and 30-year mortgages, and years left to save for retirement. And the more corporations think about the long-term sustainability of their businesses, the better off workers, shareholders, managers, and customers will be.

Corporations spent more than $800 billion on stock buybacks last year. [1]

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[1] *https://www.axios.com/stock-buybacks-increased-2018-apple-3ff90545-53f7-41e2-b774-d78ae24ec9af.html*

That money doesn't end up in the pockets of the company's workers—it goes right in the pockets of the CEOs and other corporate managers making the decision.

Last year, for the first time in a decade, corporations spent more on their own stock than on investing in long-term capital expenditures and worker investments.[2]

We know when companies ignore long-term risks, workers, small-time investors, and consumers all pay the price.

Look at Wells Fargo—the company exploited its workers with unsustainable expectations to boost its stock value, while the board lavished the CEOs with pay raise after pay raise. And consumers are still paying the price.

But it's not just consumers—it's bad for the company. Wells Fargo has faced scandal after scandal, fines and enforcement actions, and the worst stock performance among the biggest banks. And just last week, for the second time in 2½ years, the CEO stepped down under the cloud of the scandals.

Study after study tell us that investors who pay attention to how companies affect workers and communities and the environment do better over time.

But it's not always easy to figure out which companies are thinking long-term, and which companies are only thinking about the next round of stock buybacks. We need to make that critical information available to the public.

Most of the SEC's disclosure requirements were adopted almost 40 years ago, when more than 80 percent of S&P 500 companies' assets were fixed, like buildings and factories. Today, the numbers are flipped—more than 80 percent of S&P 500 assets are intangible—we're talking about brand names, patents, and investments to enhance worker skills and effectiveness.

To address that evolution, the SEC Investor Advisory Committee last Thursday recommended to the Commission that companies include new human capital management disclosures in their public filings.

Adding human capital disclosure is just a start. Investors know there are many environmental, social, or political risks that could reduce long-term value, but companies are not providing that information.

So the SEC should act. Enhancing and standardizing these disclosure requirements will merely bring the SEC up-to-date with other rules around the world.

But disclosure is only one step. It's time that companies realize that holding executives and directors accountable, respecting workers, and planning for long-term risks instead of short term payouts for CEOs is good for business.

Instead, corporations have spent their time lobbying against important tools that allow shareholders to hold corporate boards and management accountable.

Corporate special interests want to limit investors' freedom to manage and run their funds.

And they want to silence the voices of Main Street investors by making it harder for shareholders to petition companies to allow all the shareholders to vote on issues significant to the company.

Never mind that corporations never want Government to step in to protect servicemembers from banks that repossess their cars, or protect families from getting trapped in a downward spiral of debt with a payday lender.

But now all of a sudden, these rich CEOs want Government to step in to protect them from ordinary investors and ordinary Americans who are trying to make their voices heard on climate change, on protecting Americans from gun violence, on treating workers with respect. So much for limited Government.

It shouldn't take a crisis to focus executives and directors on the essentials of long-term planning. But too often short-term thinking takes over, and workers, shareholders, and customers suffer.

Just ask Wells Fargo.

I look forward to hearing from the witnesses.

Thank you, Chairman Crapo.

PREPARED STATEMENT OF PHIL GRAMM

FORMER U.S. SENATOR

APRIL 2, 2019

Chairman Crapo and Ranking Member Brown, it is a privilege to testify before the Committee I served on and chaired for 18 years. I accepted your invitation because I believe the debate about how corporate governance is structured and who money works for will have a profound impact on our prosperity and freedom. I re-

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[2] *https://www.axios.com/stock-buybacks-2018-2019-record-high-54f64348-bcd8-48c4-ae15-da2ef959dcb3.html*

spect the opinions and good intentions of those who would collectivize America's corporate structure, but I believe such policies would hurt the very people they seek to help.

The Enlightenment liberated mind, soul, and property, empowering people to think their own thoughts, worship their own gods, and benefit from the fruits of their own labor and thrift. As labor and capital came to serve their owner, not the crown, the guild, the church, or the village, medieval economies began to awaken from a thousand years of stagnation. The Parliament in England stripped away the leaching influence of royal charters and initiated reforms that ultimately allowed businesses to incorporate by simply meeting preset capital requirements. Parliament further established in law the principle that business would be governed by the laws it passed, in a process of open deliberation, not by the corrosive influences and rampant cronyism that were pervasive in the medieval marketplace.

The Enlightenment recognized that the crown, guild, church, and village had become rent seekers, leaching away the rewards for work, thrift, and innovation and in the process reducing productive effort and progress. The Enlightenment principle that labor and capital were privately owned property and not communal assets subject to involuntary sharing, unleashed an explosion of knowledge and production, creating a never before equaled human flourishing that continues to this day.

Extraordinarily in America, the crown jewel and greatest beneficiary of the Enlightenment, political movements are afoot that seek to overturn the individual economic rights created in the Enlightenment and return to a medieval world of subjects and subjugation. Today we hear proposals to force businesses to again swear medieval fealty to "stakeholders"—the modern equivalent of crown, guild, church, and village—"the general public . . . the workforce . . . the community . . . the environment . . . societal factors." These stakeholders would not have to "stake" any of their toil or treasure, but, as they did in the Dark Ages, they would claim communal rights to share the fruits that flow from the sweat of the worker's brow, the saver's thrift and the investor's venture.

Whereas the Enlightenment was based on the principle that people owned the fruits of their labor and thrift, America now faces a host of proposals to force the sharing of economic rewards that take us back to the medieval concept of communal property where the powerful few could extort part of the fruits of your labor and capital using the logic that if you own a business "you didn't build it."

Thankfully, many of these proposals to overturn the Enlightenment's concepts and benefits of economic freedom would at least employ its democratic process by seeking to change the law. This latest struggle for the survival of economic freedom and prosperity will be played out in elections during the next decade. But an even greater threat to the Enlightenment's economic foundations comes today from the surreptitious battle now being waged in stockholder meetings and corporate board rooms across the country. Today political activists are pressuring corporate America to adopt political, social and environmental policies that would subvert labor and capital in ways that have been rejected by State Legislatures, the Congress, and the Courts.

Past reforms by Congress, the SEC and the courts, designed to enhance shareholder rights, have unintentionally empowered special interest groups to subvert corporate governance, forcing corporations to deal with political and social problems they were never designed or empowered to deal with. The explosion of index funds, whose managers vote shares they do not own, has dramatically increased the danger posed by political activists not just to American corporate governance but to our prosperity and freedom as well.

Today index funds hold 17.2 percent of all U.S. shares and are the largest shareholder in 40 percent of all U.S. companies. Their future growth seems guaranteed by the tremendous price advantage gained by simply buying a slice of various equity indices rather than incurring the cost of analyzing each investment. But such efficiency is not free. An index fund's profitability is not significantly affected by the performance of any given company in the index since their primary competitors sell the same indices. Therefore index funds and their proxy advisers have neither the knowledge nor the aligned interest to make informed judgements on business-specific questions that arise in the stockholder meetings of the companies in which they control an ever-increasing share of stockholder votes.

When index funds vote their investor's shares on broad social and political issues, the problem is not just the lack of aligned interest and knowledge, the problem is that index funds have a glaring conflict of interest. On those high profile issues, the profitability of the scale-driven index fund business will be affected largely by how the public perceives the vote the fund cast and how that vote affects the marketing of the firm. The index funds financial interest, therefore, can and often will conflict with the investor's interest.

Before his death, the great Jack Bogle, founder of Vanguard, urged legislation to explicitly impose a fiduciary duty on funds "to vote solely in the interest of the fund's shareholder." Anybody voting somebody else's shares or advising on how to vote those shares should be bound by strict fiduciary responsibility. But even enhanced fiduciary responsibility won't solve the inherent conflict of interest that index funds face in voting investor shares on high profile social and political issues that have a potential impact on the marketability of the fund. On those issues maybe it is time for the SEC to require that index funds poll their investors and vote their shares only as specifically directed. We cannot allow the economic interest of index funds to effectively convert "private purpose" C corporations into "public benefit" B corporations which the investors in general index funds didn't invest in.

History teaches us that if we want to be prosperous and free, within the Rule of Law, we must let private interest create wealth and reap the rewards of its creation. Only after wealth has been created should we debate the cost and benefits of taxing and redistributing it.

PREPARED STATEMENT OF JAMES R. COPLAND

SENIOR FELLOW AND DIRECTOR, LEGAL POLICY, MANHATTAN INSTITUTE FOR POLICY RESEARCH

APRIL 2, 2019

Chairman Crapo, Ranking Member Brown, and Members of the Committee, I would like to thank you for the invitation to testify today. My name is James R. Copland. Since 2003, I have been a senior fellow with and director of legal policy for the Manhattan Institute for Policy Research, a public-policy think tank in New York City. Although my comments draw upon my research conducted for the Manhattan Institute,[1] my statement before the Committee is solely my own, not my employer's.

Today's topic has been a significant focus of my research.

U.S. capital markets continue to lead the world. But changes in those markets potentially imperil that leadership place. These changes should prompt careful scrutiny from Congress and regulators at administrative agencies including the Securities and Exchange Commission. I want to focus my testimony on three central points:

1. Shareholder voting today is dominated by institutional investors.
2. Many of these institutional investors, and other intermediaries, are subject to capture by interest groups with values misaligned from those of the ordinary diversified investor and in tension with efficient markets and capital formation.
3. American corporate law and securities regulation, to date, have not been equipped to address this problem.

Institutional Investors

Institutional investors—such as mutual funds, index funds, pensions, and hedge funds—own 70 percent of the outstanding shares of publicly traded corporations in the United States.[2] The percentage of corporate shares held by institutional investors has increased over time.[3] That's not surprising. Institutional investors have much to offer the ordinary investor, who can outsource investment decisions to knowledgeable professionals and diversify holdings even with limited assets.

But this outsourcing of capital also has risks. Ordinary investors generally lack the capacity to oversee those to whom they entrust their investment resources. The costs of the principal (in this case, the investor) monitoring the agent (in this case, the institution managing the investor's funds) are called "agency costs" in the economic literature.

Federal law attempts to protect ordinary investors who entrust others with their capital. Mutual funds serving general investors must comply with the Investment Company Act of 1940. Retirement funds, except those managed by State and local

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[1] Some language in this testimony may be substantially similar to, or in some places identical, to that in my previous publications and earlier testimony before other Government bodies.

[2] Broadridge and PricewaterhouseCoopers, "Proxy Pulse: 2017 Proxy Season Review", Sept. 2017, available at *https://www.pwc.com/us/en/services/governance-insights-center/library.html.*

[3] See Matteo Tonello and Stephan R. Rabimov, "The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition", The Conference Board Research Report, No. R-1468-10-RR, 27, 2010, available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1707512.*

governments or religious institutions, must comply with the Employee Retirement Income Security Act of 1974.

The Fink Letter

Yet the law has little to say about how such institutional investors exercise their voting rights as shareholders.[4] In a winter 2018 letter to shareholders, BlackRock chief executive officer Laurence Fink suggested "a social purpose" for corporations benefiting all "stakeholders," not merely corporate shareholders:

> Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.

BlackRock manages more assets than any other institutional investor in the world. To some degree, Fink's evoked a truism. But his letter nevertheless provoked controversy because it weighed in on one side of a debate that has raged on for a century—and, in one reading, embraced what has generally been the minority view, at least in terms of legal responsibilities.[5]

Equity Ownership and Agency Costs

Just as institutional investment vehicles provide enormous value to individuals who wish to invest their assets, equity ownership is central to financing innovation and productive investment. By raising capital with equity rather than debt, entrepreneurs can finance their ventures from dispersed sources without placing any obligation to pay funders an immediate or regular cash flow. It is hardly by accident that common-stock ownership structures, which emerged in the early 17th century in Holland and Britain, remain the principal form of ownership for large, complex profit-making institutions today. I fully concur with Senator Gramm that our unparalleled economic success is closely linked to these ownership structures.

But just as outsourcing investments has risks, so does equity ownership. Equity investors, unlike other corporate stakeholders, are unable to protect their interests

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[4] In the late 1980s, the U.S. Department of Labor issued a guidance letter instructing retirement benefit funds governed by ERISA to vote their shares according to a "prudent man" standard. See Letter from U.S. Department of Labor to Helmuth Fandl, chairman of Retirement Board, Avon Products, Inc. (Feb. 23, 1988); see also 73 FR 61731 (Oct. 17, 2008). In 2003, the SEC clarified that similar fiduciary duties attach to mutual funds and other registered investment companies. See 68 FR 6585 (Feb. 7, 2003) ("The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own" (internal citations omitted)).

[5] Shareholder primacy—the notion that corporate managers have a near-exclusive fiduciary obligation to shareholders rather than other corporate "stakeholders"—is deeply rooted in American law. It traces at least as far back as Dodge v. Ford Motor Company, in which the Michigan Supreme Court ruled that Henry Ford had a fiduciary duty to manage Ford Motor Company for the benefit of shareholders rather than employees or the broader community. 170 N.W. 668. (Mich. 1919).

In the academic literature, Adoph Berle and Gardiner Means were early defenders of the primacy of shareholders' interests in governing corporate managers' fiduciary duties. See Adolph A. Berle and Gardiner C. Means, "The Modern Corporation and Private Property" (1932) (the classic exploration of agency costs in the American corporation). Shareholder primacy was buttressed by later law and economics articles conceiving of the corporate form as a nexus of contracts. See, e.g., Armen A. Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization", 62 *Am. Econ. Rev.* 777 (1972); Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure", 3 *J. Fin. Econ.* 305 (1976).

Notwithstanding the more modern push for "corporate social responsibility," cf. Christopher Stone, "Where the Law Ends" (1975); Ralph Nader, Mark Green, and Joel Seligman, "Taming the Giant Corporation" (1976); but see David L. Engel, "An Approach to Corporate Social Responsibility", 32 *Stan. L. Rev.* 1, 1 (1979) ("Any mandatory governance reforms intended to spur more corporate altruism are almost sure to have general institutional costs within the corporate system itself. . . . But the proponents of 'more' corporate social responsibility have never bothered to analyze or examine, from any clearly defined starting point, even just the benefits they anticipate from reform . . . ."), the legal duties of corporate managers have remained essentially shareholder-focused. Cf. Elizabeth Warren, "Companies Shouldn't Be Accountable Only to Shareholders", *Wall St. J.*, Aug. 15, 2018 (implicitly acknowledging shareholder primacy as the operative legal norm in pushing a reorienting of legal duties through the Accountable Capitalism Act); James R. Copland, "Senator Warren's Bizarro Corporate Governance", *Economics21.Org*, Aug. 16, 2018, available at *https://economics21.org/warren-backwards-corporate-governance* (criticizing Senator Warren's proposal as inconsistent with three pillars of U.S. corporate law—corporate federalism, shareholder primacy, and director independence).

by contract. The agency costs of equity ownership, like those of institutional investing, are very real.[6]

American corporate law has been oriented chiefly around managing equity owners' agency costs. Common law "fiduciary duties," enforceable in court, prohibit management self-dealing. Moreover, shareholders are protected by their voting rights—chiefly, the ability to elect directors who oversee management. And in companies whose shares are traded on public stock exchanges—the regulation of which has been the province of the Federal Government since the 1930s—equity investors are able to exit their investments easily, by selling their shares. Federal securities law aims to require sufficient disclosures to permit equity owners to exercise such exit rights with good information.

Who's Monitoring the Monitors?

The central question before the Committee today involves the intersection of institutional investing and shareholder voting rights.

In general, shareholder voting rights have been thought of as a tool—complementary to legal fiduciary duties and market exit rights—to mitigate agency costs between corporate managers and equity owners. But such voting rights today are dominated by institutional investors. And most of these institutional investors themselves have substantial agency costs, between fund managers and individual investors.[7] Institutional investors—either directly or through other intermediaries, such as proxy advisory funds—are monitoring corporate boards and managers. But who's monitoring the monitors?

The answer is decidedly not the ordinary, average investor. Individual investors delegate their investment decisions to intermediaries precisely to avoid complexities like the minutiae of proxy voting. Individuals may shift their assets from one fund manager to another; but such moves will be prompted by relative portfolio performance, or fee structure, or public controversy—not by shareholder voting.

To be sure, some investors will prefer various social-investing goals for their assets. That's why social-investing vehicles like Mr. Streur's have been able to raise significant amounts of capital. Nothing in my comments should be taken to disparage the appropriateness of such investment vehicles for investors who prefer them. But recognizing that an institutional fund manager's social-investing goal may be appropriate for the informed investor who embraces that goal does not imply that such a social-investing goal is appropriate for institutional asset managers that do not clearly announce to investors their social purpose. And it does not imply that such a social-investing goal should be imported more generally into our investment, securities, and corporate laws, nor that such laws should enable actors pursuing such goals to impose them on corporate managers.

Shareholder Voting and Special Interests

Unfortunately, our current body of Federal securities laws, as interpreted and enforced by the Securities and Exchange Commission, have very much been enabling special interests. Under current SEC rules, any shareholder in a publicly traded corporation that has held at least $2,000 in stock for at least a year may place a proposal on the company's proxy ballot.[8] A shareholder can introduce the same pro-

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[6] As a general matter, equity ownership has substantially higher agency costs than alternative forms of ownership. See generally Henry Hansmann, "The Ownership of Enterprise" 35–49 (1996). Equity ownership has long been the dominant form of organization for complex profit-making businesses because its other costs of ownership—costs of collective decision making and costs of risk-bearing—are substantially lower than alternative ownership forms'. See id. Efforts to turn homogeneous fiduciary duties (centered on shareholder wealth maximization) into heterogeneous fiduciary duties (responsive to various "stakeholder" interests) directly undercut the low costs of collective decision making that have made equity ownership a preferred structure for large business organizations. See Stephen M. Bainbridge, "The Case for Limited Shareholder Voting Rights", 53 *UCLA L. Rev.* 601 (2006) (arguing that increasing the power of shareholders to hold managers accountable, including through increased disclosure, imposes significant costs in reduced managerial authority). See generally Kenneth J. Arrow, "Social Choice and Individual Values" (1963) (articulating Arrow's Impossibility Theorem, which holds that, given certain fairness criteria, voters facing three or more ranked alternatives cannot convert their preferences into a consistent, community-wide ranked order of preferences).

[7] There are exceptions. Some institutional investors, such as hedge funds, are substantially owned by their managers. These funds' agency costs are limited precisely because the fund managers have a large ownership stake—and thus a substantial interest in the funds' performance. Of course, such funds may pursue the idiosyncratic interests of their owner-managers.

[8] See 17 CFR §240.14a-8 (2007).

The SEC determines the procedural appropriateness of a shareholder proposal for inclusion on a corporation's proxy ballot, pursuant to the Securities Exchange Act of 1934, Pub. L. No. 73-291, Ch. 404, 48 Stat. 881 (1934) (codified at 15 U.S.C. §§78a–78oo (2006 & Supp. II 2009)),

Continued

posal year after year, even when 90 percent of all voting shareholders consistently oppose it.[9]

These rules have enabled special-interest shareholders to capture the attention of corporate boards and managers, at all other shareholders' expense. For example, when McDonald's stockholders gathered for the company's annual meeting in 2017, they had to vote on seven shareholder proposals. Among these were a proposal against the company's use of antibiotics in its meat supply, brought by the Benedictine Sisters of Boerne, Texas; and one by the nonprofit Holy Land Principles, which wanted the company to modify its employment practices in Israel. The Boerne Sisters owned 52 McDonald's shares. The Holy Land group owned 47. No shareholder sponsoring a proposal at the company's annual meeting that year owned more than 0.0001 percent of the company's stock.

This example is not anomalous. In 2016 and 2017, a majority of shareholder proposals sponsored at Fortune 250 companies involved social or policy issues largely unrelated to share value, executive compensation, or traditional board-governance concerns. Last year, many of our largest publicly traded companies faced four or more shareholder proposals on their corporate proxy ballot, including AmerisourceBergen, AT&T, Chevron, Citigroup, Dow Chemical, DuPont, Eli Lilly, Emerson Electric, ExxonMobil, Facebook, Ford, General Electric, Google, Home Depot, JPMorgan Chase, McKesson, and Starbucks.[10] In every year for the last decade, no more than 1 percent of these shareholder proposals were sponsored by institutional investors without a social-investing purpose or orientation, or a tie to public employees or organized labor. The SEC's lenient shareholder-proposal rules have also empowered a very small number of investors with limited investment stakes to assume an outsized role in corporate-boardroom debates; three individuals and their family members—commonly called "corporate gadflies"—have sponsored between 25 percent and 45 percent of all shareholder proposals in recent years.[11]

Today, navigating the special-interest investor is simply an expected cost of being a publicly traded corporation. In February, jeans-maker Levi Strauss filed the paperwork to become a publicly traded corporation. In March, the People for the Ethical Treatment of Animals announced it was acquiring shares in Levi's in order to propose shareholder resolutions involving the manufacturer's use of leather patches. PETA's decision was not related to investment concerns; it announced it was acquiring the minimum number of shares required to reach the SEC's $2,000 threshold.[12]

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at §§78m, 78n, and 78u; 15 U.S.C. §§80a-1 to 80a64 (2000) (pursuant to Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 841 (1940)); but the substantive rights governing such measures and how they can force boards to act remain largely a question of State corporate law: as the Supreme Court emphasized in its 1987 decision in CTS Corp. v. Dynamics Corp., "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders." 481 U.S. 69, 89.

The section of the Securities Exchange Act upon which Rule 14a-8 is promulgated, §14(a), is principally designed to ensure corporate disclosures to shareholders to afford investment information and prevent deception. See J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964) ("The purpose of §14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation."). In its 1990 Business Roundtable decision, the D.C. Circuit Court of Appeals explained further:

That proxy regulation bears almost exclusively on disclosure stems as a matter of necessity from the nature of proxies. Proxy solicitations are, after all, only communications with potential absentee voters. The goal of Federal proxy regulation was to improve those communications and thereby to enable proxy voters to control the corporation as effectively as they might have by attending a shareholder meeting.

Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) ("While the House Report indeed speaks of fair corporate suffrage, it also plainly identifies Congress's target—the solicitation of proxies by well informed insiders 'without fairly informing the stockholders of the purposes for which the proxies are to be used.'" (citing H.R. Rep. No. 1383, 73d Cong., 2d Sess. 14 (1934))). See also S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934) (characterizing purpose of proxy protections as ensuring stockholders' "adequate knowledge" about the "financial condition of the corporation").

[9] See Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 40,018; 63 FR 29,106, 29,108 (May 28, 1998) (codified at 17 CFR pt. 240).

[10] This list of companies is underinclusive. Some other companies received multiple shareholder proposals that they ultimately excluded from their proxy ballots after asking for, and receiving, "no action" letters from the SEC.

[11] The broader problems with the SEC's Rule 14a-8 are beyond the scope of this testimony. For a deeper dive into those issues, see my House subcommittee testimony on the subject from fall 2016, referenced and linked at the end of this statement.

[12] Tanya Garcia, "PETA Takes a Stake in Levi's To Press for Vegan Leather Patches", *Marketwatch*, Mar. 22, 2019, *https://www.marketwatch.com/story/peta-takes-a-stake-in-levis-to-press-for-vegan-leather-patches-2019-03-22*.

Historically, groups like PETA have been able to garner significant attention through introducing proxy ballot items but have been unable to win the support of a majority of shareholders for their precatory ballot items. But some caution is in order. Beyond institutional investors with an express social-investing purpose, many investment vehicles with large holdings are affiliated with organized labor. In 2011, the Office of the Inspector General of the Department of Labor found that labor pension funds may be using "plan assets to support or pursue proxy proposals for personal, social, legislative, regulatory, or public policy agendas."[13] Pension funds managed for State and municipal public employees, which are often wholly or partly controlled by partisan elected officials, have often overtly pursued social goals in managing their investment resources, as well as in voting shares.

The Role of Proxy Advisory Firms

Proxy advisory firms can serve to amplify such special-interest advocacy. To manage their proxy voting, institutional investors rely heavily on a pair of proxy advisory firms, Institutional Shareholder Services, or ISS, which is today owned by private-equity firm Genstar Capital;[14] and Glass, Lewis & Co., a subsidiary of the Ontario Teachers' Pension Plan Board.[15] Together, these two proxy advisors control approximately 97 percent of the market for proxy advisory services, with ISS alone having about a 61 percent share.[16] By its own estimation, ISS annually helps approximately 2,000 clients execute nearly 10.2 million ballots representing more than 4.2 trillion shares.[17]

As summarized in a 2018 report I coauthored with Stanford's David Larcker and Brian Tayan, a substantial body of empirical evidence shows that proxy advisory firms' recommendations influence institutional investor voting and that publicly traded companies are influenced by proxy advisor guidelines.[18] A 2012 analysis I coauthored showed that an ISS recommendation "for" a given shareholder proposal, controlling for other factors, was associated with a 15-percentage-point increase in the shareholder vote for any given proposal.[19] As Leo Strine, a former chancellor on the Delaware Court of Chancery, observed: "Powerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues."[20]

My report with professors Larcker and Tayan also cites a substantial body of empirical evidence demonstrating that at least some proxy-advisor advice may not be in the average shareholder's interest. Notwithstanding its substantial influence over shareholder voting, ISS is a relatively small operation. Prior to its 2014 private acquisition, ISS had just over $15 million in profits on $122 million in revenues.[21] Its small size makes ISS particularly vulnerable to capture, if it is being managed to maximize its profits. And ISS's voting guidelines have generally shown a propensity to support various social and environmental proposals, much more so than the

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[13] Dep't of Labor, Office of the Inspector General, "Proxy-Voting May Not Be Solely for the Economic Benefit of Retirement Plans", (2011), available at *http://www.oig.dol.gov/public/reports/oa/2011/09-11-001-12-121.pdf*.

[14] See Genstar Capital: Institutional Shareholder Services, *https://www.gencap.com/companies/iss/*.

[15] See Robyn Bew and Richard Fields, "Voting Decisions at U.S. Mutual Funds: How Investors Really Use Proxy Advisers", 6 (Tapestry Networks, Inc. and Investment Research Center Institute, June 2012), *http://www.tapestrynetworks.com/issues/corporate-governance/upload/Voting-Decisions-at-US-Mutual-Funds-June-2012.pdf*.

[16] See James K. Glassman and J. W. Verret, "How To Fix Our Broken Proxy Advisory System", 8 (Mercatus Center, George Mason Univ., 2013), available at *http://mercatus.org/sites/default/files/Glassman__ProxyAdvisorySystem__04152013.pdf*.

[17] Institutional Shareholder Services, About ISS, *http://www.issgovernance.com/about/aboutiss*.

[18] See James R. Copland et al., "Proxy Advisory Firms: Empirical Evidence and the Case for Reform" (Manhattan Institute 2018), available at *https://media4.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf*.

[19] See James R. Copland et al., "Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism" 22–23 (*Manhattan Inst. for Pol'y Res.*, Fall 2012), available at *http://www.proxymonitor.org/Forms/pmr__04.aspx*.

[20] Leo E. Strine, Jr., "The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face", 30 *Del. J. Corp. L.* 688 (2005).

[21] See MSCI 2013 Annual Report 70, "Summary of Operations", "Governance", available at *http://files.shareholder.com/downloads/MSCI/3458217323x0x739303/DAB046E7-737E-43C7-9114-040465AD560E/2013__Annual__Report.pdf*. ISS was acquired by Genstar in September 2017 for a reported $720 million. See Nikhil Subba and Diptendu Lahiri, "Genstar Capital To Buy Proxy Advisory Firm ISS for $720 Million", *Reuters*, Sept. 7, 2017, available at *https://www.reuters.com/article/us-institutional-shareholder-services-m/genstar-capital-to-buy-proxy-advisory-firm-iss-for-720-million-idUSKCN1BI20C*. This valuation implies significant realized growth—or anticipated future growth—for ISS. But the proxy advisor's market valuation remains very small relative to its influence over stock market proxy voting.

median shareholder. Historically, ISS has backed some 70 percent of shareholder proposals related to political spending, 45 percent of those related to employment rights, and 35 percent of those related to human rights or the environment[22]—a sharp contrast to the dearth of average shareholder support for these proposal classes. In general, ISS support for these social issues has been increasing.

Institutional Investors, Agency Costs, and Shareholder Voting

With trillions of assets under management, large mutual fund families are less susceptible to capture than proxy advisors. But at least some large, diversified mutual funds have also been moving to support some social and environmental causes in discussions with corporate managers. On March 7, 2017, State Street Global Advisers, the world's third-largest institutional investor, launched a campaign to pressure companies to add more women to their boards—symbolically installing a bronze statue, "Fearless Girl", facing the iconic "Charging Bull" that has graced Wall Street since 1989. Less than a week later, BlackRock, the world's largest mutual fund company, announced that it, too, would prioritize talking with companies on "gender balance on boards," as well as "climate risk." And by the next winter, Fink issued his letter.

Had institutional investors suddenly decided that their previous reluctance to embrace social and environmental causes had been misguided—and that these issues were now key factors in maximizing share return? The answer is almost surely no, however fund families spin their efforts through public-relations releases. In the winter of 2017, Walden Asset Management and other social-investing and public-pension investors had introduced a proposal at BlackRock, scheduled for the investment firm's own May 2017 annual meeting.[23] The proposal asked BlackRock to clarify its own voting policies on social and environmental shareholder issues. Reportedly, the social investors' "move was partly motivated by frustration [that] BlackRock and some other large shareholders like Vanguard . . . declined to support a single shareholder proposal on board diversity or climate change in 2016."[24] Walden and other investors made similar pushes at JPMorgan Chase, Bank of New York Mellon, T. Rowe Price, and Vanguard.

The sponsors of the 2017 socially oriented proposals did not manage many assets relative to BlackRock. In total, the sponsoring investors managed $3.5 billion; BlackRock manages some $5 trillion. Still, the reaction of BlackRock, State Street, and other fund families may reflect economic self-interest. Such funds' fee structures tend to be a function of assets under management. Thus, such institutional investors may be sensitive to marginal investors' preferences: a sustained and successful effort to divest from a large mutual-fund family could cause a drop in the funds' assets under management.

To be sure, assets under management will also be highly sensitive to investment returns. But the relevant figure for investment returns is relative to other fund managers. A general decline in market performance over some baseline will negatively affect fund performance over the long run, but in the short run, an asset manager's earnings are likely to be much more sensitive to an asset-divestment campaign. This is particularly true if other institutional investors are making parallel choices—as a divestment-style campaign against an institutional investor would be much more likely to have an impact if a fund was an outlier among its peers. Thus, social-investing activists may be able to engender a "cascade" effect among fund managers; once one succumbs to a pressure campaign, others will follow.

Such risks are heightened by the fact that portfolio managers themselves—those who buy and sell securities for institutional investing fund families—tend not to involve themselves heavily in shareholder voting. A survey of 64 asset managers and owners with a combined $17 trillion in assets, sponsored by RR Donnelley, Equilar, and the Rock Center for Corporate Governance at Stanford University, finds that portfolio managers are only moderately involved in voting decisions. Among large institutional investors with assets under management greater than $100 billion, portfolio managers are involved in only 10 percent of voting decisions.[25]

Rather than portfolio managers, large institutional investors tend to have in-house corporate-governance teams to handle proxy voting matters. These in-house positions are often staffed by former employees of proxy advisors—thus sharing

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[22] See Copland et al., supra n. 23, at 22–23.

[23] See Emily Chasan, "BlackRock Finds Shareholder Action Goes Both Ways", *Bloomberg Briefs*, Mar. 16, 2017, available at *https://newsletters.briefs.bloomberg.com/document/ZAq33YrjbIsCER50poBT1g__9ez25goq72ezes8vkh/front*.

[24] Id.

[25] See David F. Larcker et al., "2015 Investor Survey: Deconstructing Proxies—What Matters to Investors", Feb. 2015, *https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survyey-2015-deconstructing-proxy-statements__0.pdf*.

those proxy advisors' biases—or are otherwise at least somewhat committed to environmental- or social-investing causes. State Street, the world's third-largest institutional investor, delegates oversight of these issues to Rakhi Kumar, head of ESG investments and asset stewardship. Ms. Kumar has no apparent experience trading in securities,[26] but she envisions for herself a broad role in overseeing aspects of corporate management both broad and granular: at the SEC's proxy process roundtable in November 2018, Ms. Kumar talked about how she was working with corporate executives to change terms of maternity leave and to manage hog farms in North Carolina. It is hard to see what specialized expertise Ms. Kumar has over hog farming. But when shares are concentrated in large fund families' hands—and proxy advisors like ISS threaten to withhold support for corporate directors who fail to act upon any shareholder proposal that receives majority shareholder support[27]—it's little wonder that company leaders pay attention.

Such sweeping policy oversight by institutional investors is far afield from the agency costs shareholder voting rights are intended to mitigate. It is particularly strange when employed by index funds. The premise of such funds is to leverage capital-market efficiency and minimize active management costs—in essence, to follow the stock market. Yet in shareholder-voting decisions, such fund families are actively supporting efforts to modify corporate behavior. There is no clear investment-based rationale for this obvious tension in strategy.

The Costs of Socially Oriented Shareholder Activism

The aggressive sweep of shareholder influence over corporate handling of far-flung social and environmental causes can hurt shareholder value. Entrepreneurs and investors tend to opt for equity ownership notwithstanding high agency costs. Aside from the risk-bearing advantages of equity, there is good reason to believe that one reason why we tend to see shareholder ownership as the dominant form of complex business organization is that it minimizes collective decision-making costs.[28] Other forms of ownership—such as employee ownership, customer ownership, and supplier ownership—can handle risk-bearing to some significant extent but tend only to exist in limited circumstances. And in such cases, rules tend to exist to limit the costs of disparate interests in decision making—like law firms' strong bias toward screening partners for a preference for very high work hours. Understanding that disparate voting interests along multiple factors can make collective action difficult requires no specialized understanding of public-choice theory—and should be quite evident to members of the United States Senate.

In 2015, the Manhattan Institute commissioned an econometric study of shareholder activism and firm value.[29] Tracie Woidtke, a professor at the Haslam College of Business at the University of Tennessee,[30] examined the valuation effects associated with public pension fund influence, measured through ownership, on Fortune 250 companies. Woidtke found that "public pension funds' ownership is associated with lower firm value" and, more particularly, that "social-issue shareholder-proposal activism appears to be negatively related to firm value."[31] As such, public employee pension funds' use of the shareholder-proposal process in an effort to affect corporate behavior in pursuit of social or policy goals may be harming the financial interests of plan beneficiaries—and ultimately State and local taxpayers—as well as, by inference, the average diversified investor.

Conclusion

In recent years, regulatory changes and changes in market ownership have combined to increase the shareholder voting power of institutional investors. Abetted by SEC rules and procedures, idiosyncratic "corporate gadflies" and institutional investors with labor affiliations and social-investing orientations have gained power in the boardroom. By coopting proxy advisory firms—and, to some degree, institutional investors facing their own significant agency costs—these activists have pursued their agendas at other shareholders' expense. At least some of this social activism appears to be depressing share value.

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[26] See "State Street Global Advisors—Who We Are: Rakhi Kumar", *https://www.ssga.com/global/en/about-us/who-we-are/team.bio.36520799.html.*

[27] See ISS, "United States Proxy Voting Guidelines: Benchmark Policy Recommendations", *https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf*, at 13.

[28] See Hansmann, supra n. 10.

[29] See Tracie Woidtke, "Public Pension Fund Activism and Firm Value" (Manhattan Institute 2015), available at *https://www.manhattan-institute.org/html/public-pension-fund-activism-and-firm-value-7871.html.*

[30] See "The University of Tennessee Knoxville: Tracie Woidtke", *http://finance.bus.utk.edu/Faculty/TWoidtke.asp.*

[31] See Woidtke, supra n. 29, at 16.

Diagnosing the problems with the status quo is to some extent easier than proposing solutions, which is beyond the scope of this statement. I am happy to discuss ideas with Members of the Committee. I am also listing below earlier writings I have written or published. Please consider these citations incorporated by reference, and please feel free to reach out to me about any of the listed writings as well as my principal testimony. Thank you for your time and consideration.

Further Resources

Testimony

James R. Copland, Testimony before the House Financial Services Subcommittee on SEC Rule 14a-8, Sept. 21, 2016, *available at* https://media4.manhattan-institute.org/sites/default/files/T-JC-0916.pdf.

Reports

James R. Copland et al., *Proxy Advisory Firms: Empirical Evidence and the Case for Reform* (Manhattan Institute 2018), *available at* https://media4.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf.

James R. Copland & Margaret M. O'Keefe, *Proxy Monitor 2016: A Report on Corporate Governance and Shareholder Activism* (Manhattan Institute 2016), *available at* http://www.proxymonitor.org/pdf/pmr_13.pdf.

James R. Copland & Steven Malanga, *Safeguarding Public Pension Systems—A Governance-Based Approach* (Manhattan Institute 2016), *available at* https://media4.manhattan-institute.org/sites/default/files/R-JCSM-0316.pdf.

Tracie Woidtke, *Public Pension Fund Activism and Firm Value* (Manhattan Institute 2015), *available at* https://media4.manhattan-institute.org/sites/default/files/lpr_20.pdf.

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James R. Copland, "Against an SEC-Mandated Rule on Political Spending Disclosure: A Reply to Bebchuk and Jackson," 3 *Harvard Business Law Review* 381 (2013), *available at* http://www.hblr.org/wp-content/uploads/2013/10/HLB209_crop.pdf.

Columns

James R. Copland, "Senator Warren's Bizarro Corporate Governance," ECONOMICS21.ORG, Aug. 16, 2018, *available at* https://economics21.org/warren-backwards-corporate-governance.

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James R. Copland, "Getting The Politics out of Proxy Season," *Wall Street Journal*, Apr. 23, 2015, *available at* https://www.manhattan-institute.org/html/getting-politics-out-proxy-season-5461.html.

James R. Copland, "Politicized Proxy Advisers vs. Individual Investors," *Wall Street Journal*, Oct. 7, 2012, *available at* https://www.manhattan- institute.org/html/politicized-proxy-advisers-vs-individual-investors-3863.html.

PREPARED STATEMENT OF JOHN STREUR

PRESIDENT AND CEO, CALVERT RESEARCH AND MANAGEMENT

APRIL 2, 2019

Chairman Crapo, Ranking Member Brown, and Members of the Committee, thank you for the invitation to testify before you today. My name is John Streur and I am the President and Chief Executive Officer of Calvert Research and Management, an investment management firm based in Washington, DC, that invests across global capital markets. Our firm incorporates into our investment decisions information about corporations' (and other issuers of securities) exposure to, and management of, financially material environmental, societal, and governance (ESG) factors. Calvert is a subsidiary of Eaton Vance Management, a leading global asset manager based in Boston. [1]

Our firm sponsors one of the largest and most diversified families of responsibly invested mutual funds, encompassing active, and passively managed equity, fixed income, alternative, and multi-asset strategies. As of February 28, 2019, across our portfolios, we held more than 5,600 securities from over 4,800 issuers in developed and emerging markets. Our primary focus is to generate favorable investment returns for our clients by allocating capital consistent with financially material ESG analysis and through structured engagement with portfolio companies.

As a participant in the global capital markets focused on long-term value creation for our clients, we understand that most corporations and other issuers of securities deliver a strong net benefit to society, through their products and services, creation of jobs and the sum of their behaviors. The world has experienced unmatched economic growth over the course of the last century and we recognize that free market capitalism and competition have made a significant contribution in lifting living standards globally.

Today, companies and investors throughout the world are working to better understand how to further the tremendous progress that corporations, competition and capitalism create by conducting a deeper analysis of environmental and societal impacts and of corporate governance systems in place worldwide. As a firm, we are part of a rapidly expanding base of institutional investors and asset owners globally who seek to strengthen corporations and capitalism through improved performance on financially material environmental risk management, job creation, operational efficiency, and other factors understood through analysis of environmental and social impact factors.

The Evolution of ESG Investment Strategies

In recent years, interest in corporate exposure to issues such as energy efficiency, water conservation, workplace diversity and human rights has intensified. A heightened awareness of these issues among consumers and investors alike has pushed ESG investing well into the mainstream. In 2018, more than $12 trillion in the United States was invested in strategies that consider ESG criteria—a 38 percent increase since 2016.This $12 trillion represents 26 percent of professionally managed assets in the United States, which total $46.6 trillion. [2]

In 2010, there were 281 registered investment companies that incorporated ESG factors into their investment process. Last year, in 2018, that figure had risen to 730—a 2.6x increase in just 8 years. [3]

Investors are not the only ones changing their behavior—corporations are also taking action. Many companies in the United States have increased their focus on actively managing and reporting on ESG risks in order to remain competitive in the global market for products and services. Eight years ago, just 20 percent of the S&P

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[1] Calvert Research and Management ("Calvert" or "CRM") is an investment adviser registered under the Investment Advisers Act of 1940, as amended (Advisers Act). Calvert is a Massachusetts business trust formed in August 2016 as a wholly-owned subsidiary of Eaton Vance Management (EVM). On December 30, 2016, Calvert completed its purchase of substantially all of the business assets of Calvert Investment Management, Inc. (CIM). Calvert's purchase of the assets of CIM included all technology, know-how, intellectual property and the Calvert Research System and processes. After approval of the Board of Directors/Trustees and shareholders of the Calvert Funds, Calvert also became the successor investment manager to the registered investment management companies that CIM had been manager of prior to the transaction. In addition, Calvert hired the vast majority of the employees that were part of CIM's sustainability research department. As a result, references related to the activity of CIM prior to the purchase of its assets on December 30, 2016, are deemed herein to be the activity of Calvert.

[2] US SIF: The Forum for Sustainable and Responsible Investment. *2018 Report on U.S. Sustainable*. Responsible and Impact Investing Trends. Data points are as of December 31 of the preceding year.

[3] Ibid.

500 provided any type of reporting on relevant ESG risks. Today, 85 percent of companies in the S&P 500 actively report on ESG risks factors. [4]

A common misconception about ESG investment strategies is that incorporating environmental, social, and governance considerations into an investment process requires the investor to sacrifice returns. Calvert partnered with Professor George Serafeim at Harvard University to conduct research on this topic. Among other findings, we learned that firms in the top quintile of performance on financially material ESG issues significantly outperformed those in the bottom quintile. If an investor had invested $10,000 in 1993 in a portfolio of stocks performing in the top quintile on relevant ESG factors, by 2014 that portfolio would have returned more than twice that of a portfolio of stocks performing in the bottom quintile on financially material ESG factors. [5]

Exhibit. Firms with strong ESG scores significantly outperform those with weak scores

Source: Adapted from Khan, Mozaffar and Serafeim, George and Yoon, Aaron S., "Corporate Sustainability: First Evidence on Materiality," (November 9, 2016). "The Accounting Review," Vol. 91, No. 6, pp. 1697-1724. Available at SSRN: https://ssrn.com/abstract=2575912 or https://dx.doi.org/10.2139/ssrn.2575912.

Notes: The chart above illustrates the author's analysis of a large number of U.S. stocks from 1993 to 2014, ranked on the strength of their ESG commitments. The stocks were grouped into the top 20% of the universe (top ESG score) versus the bottom 20% (bottom ESG score). Past performance is no guarantee of future results. Data is for illustrative purposes only.

The business case for incorporating ESG considerations into the investment process is well grounded in empirical evidence. A recent study that aggregated the results of 2,200 studies on the topic concluded that the vast majority found positive correlations between corporate financial performance and ESG considerations that are financially material to that business. [6] Associated financial benefits included lower costs of capital, improved operating performance, and stronger free cash flow.

The rapidly growing action being taken to incorporate ESG factors into the business practices of U.S. corporations and the investment processes of U.S. investment management firms is a conscious attempt by these entities to strengthen our capitalist system and ensure U.S. firms maintain a competitive position globally. The Principles for Responsible Investment (PRI), an international network of firms incorporating ESG factors into their investment and ownership decisions that

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[4] Governance and Accountability Institute, Inc. "Flash Report: 85 percent of the S&P 500 Companies Published Corporate Sustainability Reports in 2017". March 20, 2018.

[5] George Serafeim, "The Role of the Corporation in Society: Implications for Investors", September 2015. Source: Adapted from Khan, Mozaffar and Serafeim, George and Yoon, Aaron S., "Corporate Sustainability: First Evidence on Materiality", (November 9, 2016). "The Accounting Review", Vol. 91, No. 6, pp. 1697-1724. Available at SSRN: *https://ssrn.com/abstract=2575912* or *https://dx.doi.org/10.2139/ssrn.2575912*.

[6] Gunnar Friede and Timo Busch, "ESG and Financial Performance: Aggregated Evidence From More Than 2,000 Empirical Studies". 2015. available at: *https://www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917.*

launched at the U.S.'s own New York Stock Exchange in 2006, now include over 2,300 investment firms globally as signatories. [7]

All too often, a genuine focus on ESG considerations by corporate entities and financial firms is associated with a narrow set of politicized issues, and the potential withholding of capital access or other financial products and services from lawful and legitimate businesses. Our firm seeks to inclusively invest in issuers that are positioned to capitalize on what we see as a long-term macroeconomic trend toward a more sustainable future. It is critical that the U.S. capital markets' infrastructure and regulatory policy keep pace with these global trends in order to maintain our economic competitiveness.

Disclosure Standardization of Environmental, Social, and Governance Risk Factors

Corporate disclosure standards have evolved over time to reflect changing industry trends as well as regulatory and judicial developments. Undoubtedly, there has been a great deal of discussion and debate amongst the investment community, regulatory authorities, and Members of this Committee as to the need or degree to which particular environmental, social or governance data should be disclosed by public issuers of securities. Rather than address specific proposals or existing petitions for actions on rulemaking, I would like to briefly speak to this issue's relevance as it pertains to the benefits of standardization and the competitiveness of U.S. capital markets.

In the United States, we are fortunate to have the deepest, most liquid and most developed capital market in the world. Our financial economy has proven to be a strategic competitive advantage for the Nation. The efficient flow of capital that it provides has enabled companies of all sizes to innovate, create jobs, and contribute to an enhanced quality of life for Americans. Yet, when it comes to the issue of standardizing disclosures related to ESG risk factors, we are behind many other developed economies around the globe.

As I mentioned earlier, 85 percent of companies in the S&P 500 already actively report on ESG risk factors voluntarily, through corporate sustainability reports or other corporate disclosures. However, much of the information provided through voluntary disclosures is difficult to compare and inconsistent across issuers, resulting in considerable costs and resource expenditure for investors. While it is impossible to discern the amount of expense incurred by investors attempting to discern ESG data, one estimate suggests that by 2020, $745 million will be spent globally on ESG data alone. [8]

The PRI, [9] along with MSCI, a global data and investment research provider, recently identified 300 policy initiatives that promoted sustainable finance in 50 of the largest economies around the globe. Two hundred of those initiatives were corporate reporting requirements covering ESG factors. [10] There are now seven stock exchanges—in Australia, Brazil, India, Malaysia, Norway, South Africa, and the United Kingdom—where companies must have some degree of environmental or social disclosure in order to meet the exchanges' requirements to list. In 2018, the China Securities Regulatory Commission introduced requirements that will mandate all listed companies and bond issuers in China disclose environmental, social, and governance risks associated with their operations. [11]

These Nations recognize that the competition for capital and investment is fiercely competitive and global in nature. Of course, the United States should always act in the best interests of its own citizens and balance concerns from a variety of constituencies. However, failing to take action to standardize ESG disclosures may afford other Nations the opportunity to shape global standards that ultimately impact U.S. capital markets and our Nation's economic competitiveness.

Finally, Calvert recognizes that as investors, our success is intrinsically linked to the success of the companies and issuers in which we are invested. We would advocate that any rulemaking or action regarding disclosure be done in a deliberate and

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[7] Principles for Responsible Investment, "About", 2018, available at: *https://www.unpri.org/pri/about-the-pri.*

[8] ESG Data: Mainstream Consumption, Bigger Spending, January 9, 2019, available at: *www.optimas.com/research/428/detail/.*

[9] Principles for Responsible Investment, "About", 2018, available at: *https://www.unpri.org/pri/about-the-pri.*

[10] PRI and MSCI, *Global Guide to Responsible Investment Regulation*, 2016, available at *https://www.unpri.org/page/responsible-investment-regulation.*

[11] Latham and Watkins LLP, "China Mandates ESG Disclosures for Listed Companies and Bond Issuers", 2018, available at *https://www.globalelr.com/2018/02/china-mandates-esg-disclosures-for-listed-companies-and-bond-issuers/.*

fair process that balances the need for reliable and complete information on ESG considerations along with limiting any unnecessary regulatory burden.

Structured Engagement and the Role of Proxy Advisory Firms

Given that the title of today's hearing explicitly addresses the role of proxy advisory firms, I would like to take this opportunity to share how our firm utilizes those services. A core part of Calvert's investment approach is structured engagement with companies and management teams in an attempt to improve both the enterprise value of the firms in which we are invested and address their environmental and social impact. We believe that active ownership is essential for improving one's position as a shareowner and that including engagement as a key element of our process is our duty as responsible stewards of our client's capital.

ESG strategies have often been characterized by the exclusion of certain companies from a portfolio because of either controversial events or objectionable products or practices. At Calvert, we believe it is best to invest as inclusively as possible and work with companies strategically to drive positive change and long-term shareholder value.

Proxy advisory firms, the two most predominant firms being Institutional Shareholder Services (ISS) and Glass, Lewis & Co. (Glass Lewis), play an important role in the institutional investment ecosystem. We are aware that ISS and Glass Lewis provide ESG-related voting recommendations and that these organizations have taken positions related to shareholder proposals on ESG topics.

Calvert views its relationship with proxy advisory firms as one that can be accurately defined as just that—an advisor. We have developed our own customized set of Global Proxy Voting Guidelines, which are publicly available on our website,[12] and outline our approach to voting on critical issues facing corporations. In addition to using a proxy advisory firm to assist in vote execution, we subscribe to custom research services so that our proxy advisor can perform the research necessary to make voting recommendations based on our Global Proxy Voting Guidelines. That said, the decisions on how and when to vote are solely Calvert's.

In an effort to remain as transparent as possible, we also post votes to the Calvert website within 72 hours of being cast and, in almost all cases, in advance of the meeting so that Calvert's clients and the general public can see how we voted on behalf of our clients. During the 2018 Proxy Season, which ran from July 1, 2017, to June 30, 2018, we voted at 4,425 meetings on issues ranging from climate change and energy to board diversity and sustainability reporting.

We believe proxy advisors serve a valuable role in providing research services to the investment industry. Further, the actual process of properly casting votes and maintaining records is transaction intensive and the ability to outsource these functions to specialized service providers provides operational efficiency to the U.S. asset management industry.

Much of the criticism that is directed toward proxy advisory firms in today's policy debate often appears from sources other than the institutional investors that voluntarily choose to utilize the services of proxy advisory firms. Ultimately, we would not favor any additional actions that would compromise the independence of the research and advice we receive from these vendors or impose unnecessary costs or burdens on investment firms.

Conclusion

I would like to again thank the Committee for allowing me the opportunity to share my perspectives on these important topics. My sincere hope is that this forum provides an opportunity for constructive dialogue on how to balance the ongoing competitiveness of U.S. capital markets, investment management firms, and corporations with the need to ensure that our capitalist system achieves the most sustainable future possible.

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[12] *https://www.calvert.com/Proxy-Voting.php*

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM PHIL GRAMM

Q.1. Index funds are increasingly voting in favor of ESG issues to amplify their public image. Investors believe voting for ESG proposals will help them recruit more investor-clients. Do you think the existing customers of index funds also support ESG issues?

A.1. I don't know whether existing customers support ESG issues or not. There are funds that are committed to promoting ESG type issues which investors could invest in if they put a premium on those issues.

Q.2. If a company is vulnerable to legal challenges based on its actions relating to ESG issues, should investors be aware of those risks?

A.2. If companies are vulnerable to legal challenges based on ESG issues you would have to assume that management, in carrying out its fiduciary responsibility, would be responsive to these concerns. If the issue is raised at a stockholder meeting anyone could make a point concerning legal liability. What legal liabilities rise to the level that the company should notify stockholders is another question altogether since companies face the potential of legal liability in literally thousands of areas.

Q.3. If ESG disclosures would put companies at risk of legal liability, should investors have this transparency to inform their future investment decisions?

A.3. If any legal liability is material to the operation of the company and its future prospects, a company would be required under current law to notify investors.

Q.4. ESG funds are part of the marketplace of options where people can invest their hard earned money and do so with quality returns. Why do you propose restricting Americans' choices to disinvest from poorly performing companies that go against their own personal values?

A.4. I don't support restricting anyone's choices. What I oppose is index funds promoting their profitability and not the well-being of their investors.

Q.5. During the hearing, you stated that an investor could offer a shareholder proposal, be the only one to vote for it, and then offer it again the next year. That is not correct. What is the minimum thresholds for shareholder proposals to be offered again in previous years?

A.5. Under current SEC rules, over 97 percent of the shareholders must vote no on a shareholder proposal or it can be put up for another vote the very next season. I misspoke in my Committee testimony.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM JAMES R. COPLAND

Q.1. If a company is vulnerable to legal challenges based on its actions relating to ESG issues, should investors be aware of those risks?

A.1. As a general matter, publicly traded corporations do regularly include risk disclaimers of this sort in public documents filed under SEC regulations. For instance, Amazon's 10-K discloses a host of risk factors, including those related to legal and regulatory matters:

> We may have limited or no experience in our newer market segments, and our customers may not adopt our offerings. These offerings may present new and difficult technology challenges, and we may be subject to claims if customers of these offerings experience service disruptions or failures or other quality issues. . . .
>
> Because we process, store, and transmit large amounts of data, including personal information, failure to prevent or mitigate data loss or other security breaches, including breaches of our vendors' or customers' technology and systems, could expose us or our customers to a risk of loss or misuse of such information, adversely affect our operating results, result in litigation or potential liability for us, deter customers or sellers from using our stores and services, and otherwise harm our business and reputation. . . .
>
> Other parties also may claim that we infringe their proprietary rights. We have been subject to, and expect to continue to be subject to, claims and legal proceedings regarding alleged infringement by us of the intellectual property rights of third parties. Such claims, whether or not meritorious, may result in the expenditure of significant financial and managerial resources, injunctions against us, or the payment of damages, including to satisfy indemnification obligations. . . .
>
> We are subject to general business regulations and laws, as well as regulations and laws specifically governing the Internet, physical, e-commerce, and omnichannel retail, electronic devices, and other services. Existing and future laws and regulations may impede our growth. These regulations and laws may cover taxation, privacy, data protection, pricing, content, copyrights, distribution, transportation, mobile communications, electronic device certification, electronic waste, energy consumption, environmental regulation, electronic contracts and other communications, competition, consumer protection, employment, trade and protectionist measures, web services, the provision of online payment services, information reporting requirements, unencumbered Internet access to our services or access to our facilities, the design and operation of websites, health and sanitation standards, the characteristics, legality, and quality of products and services, product labeling, and the commercial operation of unmanned aircraft systems. It is not clear how existing laws governing issues such as property ownership, libel, data protection, and personal privacy apply to the Internet, e-commerce, digital content, web services, and artificial intelligence technologies and services. Jurisdictions may regulate consumer-to-consumer online businesses, including certain as-

pects of our seller programs. Unfavorable regulations, laws, and decisions interpreting or applying those laws and regulations could diminish the demand for, or availability of, our products and services and increase our cost of doing business. . . .

Our contracts with U.S., as well as state, local, and foreign, government entities are subject to various procurement regulations and other requirements relating to their formation, administration, and performance. We may be subject to audits and investigations relating to our Government contracts, and any violations could result in various civil and criminal penalties and administrative sanctions, including termination of contract, refunding or suspending of payments, forfeiture of profits, payment of fines, and suspension or debarment from future Government business. In addition, such contracts may provide for termination by the Government at any time, without cause. . . .

Some of the products we sell or manufacture may expose us to product liability or food safety claims relating to personal injury or illness, death, or environmental or property damage, and may require product recalls or other actions. Certain third parties also sell products using our services and stores that may increase our exposure to product liability claims, such as if these sellers do not have sufficient protection from such claims. Although we maintain liability insurance, we cannot be certain that our coverage will be adequate for liabilities actually incurred or that insurance will continue to be available to us on economically reasonable terms, or at all. In addition, some of our agreements with our vendors and sellers do not indemnify us from product liability. . . .

The law relating to the liability of online service providers is currently unsettled. In addition, governmental agencies could require changes in the way this business is conducted. Under our seller programs, we may be unable to prevent sellers from collecting payments, fraudulently or otherwise, when buyers never receive the products they ordered or when the products received are materially different from the sellers' descriptions. We also may be unable to prevent sellers in our stores or through other stores from selling unlawful, counterfeit, pirated, or stolen goods, selling goods in an unlawful or unethical manner, violating the proprietary rights of others, or otherwise violating our policies. Under our A2Z Guarantee, we reimburse buyers for payments up to certain limits in these situations, and as our third-party seller sales grow, the cost of this program will increase and could negatively affect our operating results. In addition, to the extent any of this occurs, it could harm our business or damage our reputation and we could face civil or criminal liability for unlawful activities by our sellers.

Beyond such a broad recitation of potential risks, it is not at all prudent to have a disclosure rule for securities issuers that would,

with specificity, outline facts that might spur litigation or regulatory action. To the extent any such disclosures were factual and meaningful—and not simply recitations of general risks facing any business in a given industry—they might involve trade secrets or other proprietary information, or otherwise put businesses trading on U.S. exchanges at a competitive disadvantage relative to privately held or foreign-listed companies. To the extent a disclosure was not factual but speculative, it would be disfavored, as are speculative, forward-looking statements generally in our securities-disclosure regime. To the extent they involved actual ongoing litigation, disclosures could compromise a company's litigation position-and statements might be used in litigation as implicit admissions, even when not so intended, to the detriment of investing shareholders' interests.

Of course, there may be specific regulatory-risk issues that are sufficiently significant and material that the SEC might develop a disclosure regime as consistent with its mandate to protect investors, maintain efficient markets, and facilitate capital formation. For example, in 2010, the SEC promulgated new climate-change disclosure rules along these ends. See Commission Guidance Regarding Disclosure Related to Climate Change, Exchange Act Release No. 34-61469, 75 FR 6290, 6291, 6296. Whether or not the specific disclosure rules being promulgated were provident, this type of disclosure rule can—at least in theory—fit within a rational disclosure regime, if it involves assessments of firm assets or positions that might be particularly vulnerable to a prospective or known regulatory rule of materially sizable magnitude.

Q.2. If ESG disclosures would put companies at risk of legal liability, isn't it better for investors to have this transparency to inform their future investment decisions?

A.2. No. If a disclosure as a disclosure creates a liability risk—because an enterprising plaintiffs' lawyer could excerpt the disclosure and use it to suggest a corporate admission or to fulfill a knowledge (scienter) requirement, whether warranted or not—then that is a reason NOT to require a disclosure. Liability risks should be predicated upon facts; the last thing we should want is for our Government disclosure regime itself to facilitate spurious class-action or other mass litigation claims.

Q.3. ESG funds are part of the marketplace of options where people can invest their hard earned money and do so with quality returns. Why do you propose restricting Americans' choices to disinvest from poorly performing companies that go against their own personal values?

A.3. I do not propose "restricting Americans' choices" to invest or divest their funds in accordance with their own social or policy values, including through institutional intermediaries. To the contrary, in my written testimony, I expressly state:

> To be sure, some investors will prefer various social-investing goals for their assets. . . . Nothing in my comments should be taken to disparage the appropriateness of such investment vehicles for investors who prefer them. But recognizing that an institutional fund manager's social-in-

vesting goal may be appropriate for the informed investor who embraces that goal does not imply that such a social-investing goal is appropriate for institutional asset managers that do not clearly announce to investors their social purpose. And it does not imply that such a social-investing goal should be imported more generally into our investment, securities, and corporate laws, nor that such laws should enable actors pursuing such goals to impose them on corporate managers.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SINEMA FROM JAMES R. COPLAND

Q.1. Mr. Copland, you stated in your testimony that certain decisions that institutional investors, social-investing organizations, and proxy advisory firms have collectively made constitute "social activism" that "appear to be depressing share value." What specific examples of "social activism" can you cite where a decision on a proposal has causally depressed share value? How does one determine that a proposal has causally depressed share value?

A.1. In my testimony, I claimed that "[a]t least some [shareholder-based] social activism appears to be depressing share value." A 2015 study published by the Manhattan Institute, cited in footnote 33 [29 herein] of my long-form written testimony, forms the principal empirical basis for that claim. The study, "Public Pension Fund Activism and Firm Value: An Empirical Analysis", was conducted by Tracie Woidtke, Head of the Finance Department at the Haslam College of Business at the University of Tennessee, where she serves as the David E. Sharp/Home Federal Bank Professor in Banking and Finance. The study is available online at *https://www.manhattan-institute.org/html/public-pension-fund-activism-and-firm-value-7871.html.*

Because many factors can influence short-term stock-price movements, it is difficult to infer that any single stock-price decline is attributable to social activism on the part of a shareholder. Professor Woitdke—both in our Manhattan Institute study and in earlier research examining different questions—has asked the question using a different methodology. Professor Woidtke looks at lagged ownership data on the part of institutional investors engaged in shareholder-activism campaigns—calculated as the number of shares as a proportion of shares outstanding at the end of the preceding quarter. Using this data, Professor Woidtke conducts an econometric regression looking at the relationship between this institutional-ownership data and firm value (as measured by Tobin's Q, a measure of the contribution of the firm's intangible assets to its market value, commonly used to assess firm value in regression analyses of this type).

Because large institutional investors managing more than $100 million in assets are required by the SEC to file Form 13F ownership data on their directly owned equity shares, Professor Woidtke was able to gather such data for a large number of institutional investors, including both private mutual funds and public pension funds. And certain of these public pension funds—notably the California Public Employees Retirement System (CalPERS), California

State Teachers Retirement System (CalSTRS), New York State Common Retirement System (NYSCR), and Florida State Board of Administration (FSBA)—have over the years engaged in a variety of forms of shareholder activism, both related to social and environmental issues and related to more traditional corporate-governance and executive-compensation concerns. By comparing firm value with lagged pension-fund ownership—and assessing whether firms with shares held by the public pension fund were the targets of public shareholder-activism campaigns, as collated on the Manhattan Institute's ProxyMonitor.org database of shareholder proposals—Professor Woidtke was able to test for an average associational relationship between the activism campaign and firm value.

Professor Woidtke's study covers the years from 2001 through 2013. The public pension funds studied held in the aggregate approximately 2.5 percent of the S&P 500 companies' equity. Professor Woidtke's analysis accounts for a host of control variables found to influence Tobin's Q in prior research, including industry, firm size, prior-year firm income, firm leverage, firm research and development expenses, firm advertising expenses, firm insider ownership, firm membership in the S&P 500 stock index, firm-specific stock transaction costs, and year fixed effects. She assesses both a *Fortune* 250 and an S&P 500 dataset. Because ownership was lagged, we can broadly reverse-causality explanations.

Professor Woidtke's analysis concluded:

> Social-issue shareholder-proposal activism appears to be negatively related to firm value. In this paper, the negative relationship between public pension fund ownership and firm value is significant for firms targeted by public pension funds engaging in social-issue activism—across two different firm samples—in 2008–13, when the two large funds focused on social-issue activism, CalSTRS and the NYSCR, were engaged in shareholder-proposal activism.

Interestingly, while Professor Woidtke found that socially oriented shareholder activism had a negative relationship to firm value, she also found that "No significant valuation effect is found for ownership by public pension funds that sponsor corporate governance proposals during any period." Thus, public pension funds that tried to engage companies in shareholder-activism efforts for the "G" portion of ESG advocacy did not seem to affect share price significantly (either positively or negatively).

Q.2. Given that share value is constantly determined by a variety of factors, many of which are not within a corporate board's direct control, how do you quantify a decision's commensurate reduction in share value?

A.2. Controlling for a large number of factors, the relationship that Professor Woidtke found was strong, vis-a-vis the stylized "industry-adjusted Tobin's Q" variable, particularly for companies targeted in the social-activism campaigns of the New York State Common Retirement Fund (the most-active sponsor of shareholder proposals among public-pension funds reporting 13F ownership data):

> Consistent with social-issue activism having negative valuation effects, Tobin's Q is 22 percent lower (1.42 vs. 1.83) and industry-adjusted Tobin's Q is 141 percent lower (-0.12 vs. 0.29) for companies targeted by NYSCR with a social issue proposal than for other companies in the Fortune 250. These results are robust for companies in a larger dataset, the S&P 500, for which Tobin's Q is 21 percent lower (1.59 vs. 2.02) and industry-adjusted Tobin's Q is 91 percent lower (0.04 vs. 0.45) for companies targeted by NYSCR with a social-issue proposal than for other companies.

More than the point estimates indicated, I would focus on the statistical significance of the finding, robust across different datasets for aggregate as well as specific pension funds being studied:

> For S&P 500 firms, the negative relationship between pension-fund ownership and firm value is significant at the 1 percent level, both for ownership by all social-issue shareholder-proposal sponsoring pension funds and for the NYSCR in particular—in the full 2001–13 period and in the more recent period, but not for the earlier 2001–07 period, when neither CalSTRS nor NYSCR actively sponsored shareholder proposals.

That said, I would share your implicit concern about quantifying the share-value impact described above with specificity, certainly in a cost-benefit analysis framework. This is one study, applied for one set of investors (large public pension funds) across one time series (2001 through 2013) and one set of activism campaigns.

But that does not mean that its central findings do not offer an important cautionary tale. Large public pension funds of the sort studied in the Woidtke paper own more than $3 trillion in stock market assets. They regularly lead socially oriented shareholder-proposal campaigns. See, e.g., James R. Copland, "Proxy Monitor 2013 Finding 3, Special Report: Public Pension Fund Activism", available at *https://www.proxymonitor.org/Forms/2013Finding3.aspx*. And unlike private institutional investors that must compete for assets under management, their investment portfolios are captive (i.e., public employees who depend on these funds to manage their retirement assets cannot move their investments to another provider); and their institutional leadership is often driven by policy-related and other social concerns, see James R. Copland and Steven Malanga, "Safeguarding Public-Pension Systems: A Governance-Based Approach" (Manhattan Institute 2016), available at *https://www.manhattan-institute.org/html/safeguarding-public-pension-systems-governance-based-approach-8595.html*.

(For a discussion of how these ESG campaigns relate to such plans' fiduciary duties, see Max M. Schanzenbach and Robert H. Sitkoff, "Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee", *Stanford Law Review* (forthcoming), Northwestern Law and Econ Research Paper No. 18-22, available at *https://papers.ssrn.com/sol3/Papers.cfm?abstract__id=3244665.*)

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM JOHN STREUR

Q.1. The most recent volume of the National Climate Assessment, a scientific report issued by 13 Federal agencies in November 2018, stated that climate change may cause losses of up to 10 percent of the U.S. economy by 2100.[1] Additionally, a 2015 report from *The Economist Intelligence Unit* wrote that, of the world's current stock of manageable assets, the expected losses due to climate change are valued at $4.2 trillion by the end of the century.[2]

Would understanding which assets of public companies may be materially affected by climate change help you make more informed decisions about the risk of your investments?

A.1. Yes. The climate-related risk to individual corporate assets, overall corporate performance at the company level, and the wider financial system are currently poorly understood. The Financial Stability Board's Task Force on Climate Related Financial Disclosures (TCFD) has developed guidelines that categorize climate risk into (i) transition risk and (ii) physical risk. These disclosure frameworks represent positive developments but remain voluntary. A growing number of firms are making progress on disclosing transition related risks while far fewer have made progress on disclosing physical climate risk exposures.

Q.2. Would it be useful as an investor to understand public companies' contributions to greenhouse gas emissions and their exposure in the event of a Government- or market-mandated transition towards a lower-carbon economy?

A.2. Yes. A Government- or market-mandated transition to a low carbon economy would almost certainly require actions that would result in a direct financial impact to firms across every industry and therefore investors would be interested in understanding the nature of that particular risk exposure.

Q.3. A Government Accountability Office (GAO) report from February 2018 states, "[Securities and Exchange Commission (SEC)] reviewers may not have access to the detailed information that companies use to arrive at their determination of whether risks, including climate-related risks, must be disclosed in their SEC filings."[3] While the SEC has issued guidance for considering effects of climate change, the SEC has not mandated disclosures for how climate risk materially affects returns.

If Federal regulators do not have the information needed to fully understand public companies' climate-related risks under current law, do you as an investor have the adequate information needed to make informed decisions about companies' risks?

A.3. Many public companies do supply information related to risks associated with climate change on a voluntary basis. As an investor we find this information helpful but often incomplete. Because con-

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[1] *New York Times*, "U.S. Climate Report Warns of Damaged Environment and Shrinking Economy", Coral Davenport and Kendra Pierre-Louis, November, 23, 2018, *https://www.nytimes.com/2018/11/23/climate/us-climate-report.html.*

[2] *The Economist Intelligence Unit*, "The Cost of Inaction", 2015, p. 41, *https://eiuperspectives.economist.com/sites/default/files/The%20cost%20of%20inaction__0.pdf.*

[3] United States Government Accountability Office, "Climate-Related Risks", February 2018, pp. 17–18, *https://www.gao.gov/assets/700/690197.pdf.*

sistent disclosure is not mandated by Federal regulators, considerable information asymmetry exists. Investors that are focused on climate-related risks must conduct significant levels of diligence using information sources outside of the traditional audit and regulatory filing process. We would support a uniform standard for disclosing climate-related risks that would facilitate consistent comparison across issuers of securities.

Q.4. The GAO report also states, "Climate-related disclosures vary in format because companies may report similar climate-related disclosures in different sections of the annual filings . . . SEC reviewers and investors may find it difficult to navigate through the filings to identify, compare, and analyze the climate-related disclosures across filings, especially given the size of each individual filing."[4] There is, however, a clear desire for shareholders to understand the impacts of climate-related risks for companies, as was shown in a 2017 vote of ExxonMobil shareholders calling on the company to report on business risks associated with new technology and changes in climate policy.[5]

Do you believe that a mandatory uniform standard for disclosing climate-related risks would help you better understand how these risks may affect returns and compare across companies?

A.4. If the standard is strong, the answer would be "Yes." However, if the standard was inadequate or poor, the answer would be "No."

Q.5. In response to Senator Schatz's question of whether you think companies are doing an adequate job of disclosing material climate risk, you responded, "It's changing, but we're not close to being there yet . . . Companies themselves understand these risks fairly well."

What actions are some companies taking that demonstrate that they're aware of climate risk?

A.5. The actions taken by firms to address climate-related risk can vary considerably. Some firms have taken no action. Others have substantially taken steps to reduce the GHG footprint of their operations or incorporate more sources of renewable energy. Still others have made efforts to capitalize on the opportunities associated with the transition to a lower carbon economy and partially or completely pivoted their corporate strategy. Actions vary widely and are generally unique to the firm and industries in which they operate.

Q.6. What companies are doing the best job of disclosing climate risk and what do these disclosures include?

A.6. The Carbon Disclosure Project's (CDP) annual A List should serve as a worthwhile reference to address this question. The CDP A List names the world's businesses leading on environmental disclosure and performance. To address the question of what companies Calvert views as strong performers, we would kindly direct you to the annual Barron's annual *The 100 Most Sustainable U.S. Companies* list. The methodology for this ranking was developed by

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[4] Id.

[5] *New York Times*, "Exxon Mobil Shareholders Demand Accounting of Climate Change Policy Risks", Diane Cardwell, May 31, 2018, *https://www.nytimes.com/2017/05/31/business/energy-environment/exxon-shareholders-climate-change.html.*

Calvert Research and Management. *https://www.barrons.com/articles/these-stocks-are-winning-as-ceos-push-for-a-sustainable-future-51549657527*; *https://www.calvert.com/impact.php?post=how-we-did-it-barrons-top-100-sustainable-companies-&sku=31313.*

Q.7. How have these disclosure improvements allowed your firm to generate favorable investment returns for your clients?

A.7. ESG disclosures provide a more complete and transparent picture of company's performance relative to peers in what we view to be deep secular trends toward a more sustainable and inclusive economic system. This enables us to differentiate among issuers and select investments that may be better positioned to outperform the respective benchmark over the long term, all else being equal.

Q.8. In your written testimony, you wrote, "The efficient flow of capital that [our financial economy] provides has enabled companies of all sizes to innovate, create jobs, and contribute to an enhanced quality of life for Americans. Yet, when it comes to the issue of standardizing disclosures related to ESG risk factors, we are behind many other developed economies around the globe."[6] You go on to state that there are currently seven stock exchanges where companies are required to have some environmental or social disclosures and that failing to standardize U.S. environmental, social, and governance disclosures may allow other Nations to shape global standards.

Would requiring uniform standards for public companies to disclose critical information about their environmental risks be an adequate step forward in modernizing U.S. disclosures?

A.8. Yes, such an action would be viewed as strong progress. However, any potential disclosure mandates should consider both the costs and benefits associated with implementation as to not improperly disincentivize or disrupt access to capital.

There are currently multiple voluntary ESG related disclosure frameworks from sources such as SASB, GRI, CDP, and others. Some corporations have noted "survey or disclosure fatigue." A single, regulatory-backed set of disclosure standards would likely lower the reporting burden for companies currently reporting this information and improve the quality of what is available to investors.

Ideally, any additional disclosure requirements would be implemented as a part of a more comprehensive effort to modernize the United States' financial disclosure regime and ensure any potential regulatory burden on public firms is minimized while still ensuring we address information requirements related to the pertinent risks companies face in the 21st Century.

Q.9. What countries have the best disclosure frameworks? What makes them so useful?

A.9. The European Union has led on critical issues of ESG disclosure and performance. Please see release below from earlier this year for reference. *https://www.unepfi.org/news/industries/invest-*

[6] Written testimony of John Streur to the U.S. Senate Committee on Banking, Housing, and Urban Affairs, April 2, 2019, *https://www.banking.senate.gov/imo/media/doc/Streur%20Testimony%204-2-19.pdf.*

ment/eu-policy-makers-achieve-political-agreement-on-investor-disclosures-and-esg/

Please also reference various examples I shared in my testimony. The PRI has provided a *Global Guide to Responsible Investment Regulation*, which identified 300 policy initiatives that promoted sustainable finance in 50 of the largest economies around the globe. Two hundred of those initiatives were corporate reporting requirements covering ESG factors. *https://www.unpri.org/sustainable-markets/global-guide-to-responsible-investment-regulation/207.article*

Additionally, there are now seven stock exchanges—in Australia, Brazil, India, Malaysia, Norway, South Africa, and the United Kingdom—where companies must have some degree of environmental or social disclosure in order to meet the exchanges' requirements to list. While we do not believe China has best-in-class policies on ESG related exposure, in 2018 the China Securities Regulatory Commission did introduce requirements that will mandate all listed companies and bond issuers in China disclose environmental, social, and governance risks associated with their operations.

As we noted previously in this response, the financial economy of the United States has different characteristics than that of the European Union and other countries we have mentioned (i.e., mix of financing provided through capital markets versus the banking system). The U.S. will need to determine what disclosure regime is most optimal for its market. A regulatory backed disclosure framework that requires companies to quantitatively report the impact of only those ESG matters that are financially material to the industry in which the company does business would represent significant progress in this regard.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM JOHN STREUR

Q.1. What would you say is the average length of an investor relationship at Calvert? In your opinion, are most asset managers and pension funds interested in short-term profit or long-term gain?

A.1. Historically, the average length of an investor relationship with Calvert is over 12 years. We believe this is longer than investor relationships seen in other mutual funds. Many asset managers do attempt to apply a long-term strategic focus to investing. However, we feel that short-term thinking is prevalent in our financial markets. This is reflected in corporate sentiment, investor holding period data, and other market and human behavioral incentives that all contribute to short-term pressures that both asset managers and companies face.

Q.2. Would you agree that someone who invests their retirement savings in an index fund is the ultimate long-term investor? And if so, do you think it is the fiduciary duty of the manager of that index fund to ensure that that investor's assets are profitable over the long term and are not impacted by factors like climate change?

A.2. Investors investing their retirement savings will have different investment horizons based upon their time to retirement, but it is

likely that a significant percentage of those investors are planning to invest for the long term. Index funds managers are obligated to implement the index as created by the index provider. It would be the obligation of the fiduciary to a retirement plan to assure that the options available in the plan are appropriate investment options for plan participants.

Q.3. Would you have concerns if Congress made it more difficult for proxy advisors to provide advice to your firm?

A.3. Yes. As I stated in my testimony, we believe proxy advisors serve a valuable role in providing research services to the investment industry. Ultimately, we would not favor any additional actions that would compromise the independence of the research and advice we receive from these vendors or impose unnecessary costs or burdens on investment firms.

Q.4. Do you think ESG funds are being accurately and fairly marketed to investors?

A.4. As it pertains specifically to marketing efforts by asset managers, both regulators and FINRA have rules and have issued guidance related to the marketing of funds. If funds are subjected to standardized criteria for disclosing their ESG strategies, the result would be enhanced consistency and transparency in marketing ESG funds.

More broadly, we feel that there is a much greater opportunity for the marketplace to define what "ESG" is and what it means exactly from an investment perspective. As a result of this void, the ESG label is often used across a wide variety of strategies that range from simply considering ESG factors to fully optimizing to seek positive impact. The marketplace would certainly benefit from a more detailed taxonomy that is generally accepted. Clear, required disclosures for issuers of securities would likely assist in the development of broader clarification in the marketplace but any additional disclosure mandates for issuers should consider both the costs and benefits associated with implementation. Morningstar's Jon Hale provided a worthwhile analysis of this issue in the February 2019 report, *Sustainable Funds U.S. Landscape Report. https://www.morningstar.com/lp/sustainable-funds-landscape-report*.

Q.5. Is there a Federal role for protecting consumers by ensuring standards, consistency, and transparency in the marketing of ESG funds?

A.5. Yes. Both Federal and State regulators should act within their existing authorities as outlined by any relevant mandates. We believe that Federal regulatory disclosure guidelines that provide standards, consistency, and transparency for issuers of securities on ESG considerations would be helpful to the marketplace.

Q.6. What role does the nonprofit Sustainability Accounting Standards Board have in ensuring investors looking for financial investments that align with their values are appropriately served?

A.6. The Sustainability Accounting Standards Board (SASB) is an independent standards board that is accountable for the due process, outcomes, and ratification of the SASB standards. The SASB disclosure standards are an important tool for issuers of securities

as they provide a standardized framework at the industry level that assists interested investors in allocating capital in a manner that aligns with their values.

Q.7. Are you concerned that the Board's standards are only voluntary?

A.7. Calvert is concerned that there continues to be a lack of Federal regulatory guidance on disclosures related to environmental, social, and governance issues. We view this as a competitive disadvantage for U.S. capital markets. It is concerning that there remains a lack of clarity on the path forward for regulatory disclosure standards in the United States while other Nations move forward in an effort to modernize their financial markets.

Q.8. ESG fund offerings continue to increase; in fact they will become more and more mainstream. Who do you see fighting this inevitability and why do you believe they are fighting it?

A.8. We believe the growth in this form of investment management is indicative of, and directly commensurate to, the value that ESG information brings to investors and our economic system broadly. However, there are political constituencies and entrenched corporate interests that have business models, fixed asset bases, and financial outcomes that are not aligned with the transition to a more environmentally sustainable and inclusive economic system. For some, alignment with this secular economic shift will inherently require significant investment and adaption efforts. Constituencies and companies that find themselves misaligned with this secular pivot and unable to adapt accordingly will be most antagonistic to the growth of ESG investing.

Q.9. Who decides what is financial material? Is investor interest enough to justify the need for consistent, comparable, and complete ESG information?

A.9. Financial materiality has been addressed by both regulatory authorities and independent standard setting bodies. Generally, we view a financially material issue as one that is reasonably likely to impact the financial condition or operating performance of a company and therefore it is important to investors. If a reasonable investor could have come to a different investment decision as a result of the incorporation of certain information it is considered financially material.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER SUBMITTED BY COUNCIL OF INSTITUTIONAL INVESTORS

Via Hand Delivery

April 8, 2019

The Honorable Michael D. Crapo
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Re: April 2, 2019 Hearing on "The Application of Environmental, Social, and Governance Principles in Investing and the Role of Asset Managers, Proxy Advisors, and Other Intermediaries."[1]

Dear Mr. Chairman and Ranking Member Brown:

I am writing on behalf of the Council of Institutional Investors (CII) to express our appreciation for holding the above referenced hearing and to provide you with our views on several corporate governance related topics that are of great interest to our members and that were discussed at the hearing. We would respectfully request that this letter be made a part of the hearing record.

CII is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately $4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than $35 trillion in assets under management.[2]

[1] Hearings, United States Committee on Banking, Housing, and Urban Affairs, The Application of Environmental, Social, and Governance Principles in Investing and the Role of Asset Managers, Proxy Advisors, and Other Intermediaries (Apr. 2, 2019), https://www.banking.senate.gov/hearings/the-application-of-environmental-social-and-governance-principles-in-investing-and-the-role-of-asset-managers-proxy-advisors-and-other-intermediaries.

[2] For more information about the Council of Institutional Investors ("CII"), including its board and members, please visit CII's website at http://www.cii.org.

Human Capital Management (HCM) Disclosure

CII supports dialog that would lead to enhancements to HCM disclosures.[3] We believe that institutional and retail investors have a pronounced interest in clear and comparable information about how public companies approach HCM.[4] That interest is supported by the growing body of research that has found that high quality HCM practices correlate with better corporate performance.[5]

Human capital is an increasingly important value driver for companies, including those with securities listed on U.S. exchanges. We would note in this regard that the "ESG" label may cause confusion to the extent disclosure on human capital as a value driver and source of risk is placed within that category.

CII has a broad tent of members, some more enthusiastic on the language of "ESG" than others, but we are unaware of any segment of our membership that does not consider human capital as important to valuation of most companies, and critical in particular for certain growth sectors.[6] And historically, corporate disclosures on human capital have been limited, in part because of the importance of intangible factors not easily quantified.

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[3] Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to The Honorable Jay Clayton, Chairman, Securities and Exchange Commission 1 (Oct. 10, 2017), https://www.cii.org/files/issues_and_advocacy/correspondence/2017/10-6-17%20CII%20letter%20to%20SEC%20on%20HCM.pdf ("CII believes that the . . . U.S. Securities and Exchange Commission . . . [should] . . . further explor[e] . . . the need for enhancements to HCM disclosures.").

[4] *See* Recommendation from the Investor-as-Owner Subcommittee on Human Capital Management Disclosure 2 (approved Mar. 28, 2019), https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac032819-investor-as-owner-subcommittee-recommendation.pdf ("Institutional and retail investors have a pronounced interest in clear and comparable information about how firms approach HCM"); *see also* Chairman Jay Clayton, Remarks for Telephone Call with SEC Investor Advisory Committee Members (Feb. 6, 2019), https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-call-020619 ("for human capital, I believe it is important that the metrics allow for period to period comparability for the company").

[5] *See* Letter from Dr. Anthony Hesketh, Department of Organization, Work & Technology, Lancaster University Management School to Anne Sheehan, Chairman Investor Advisory Committee, U.S. Securities and Exchange Commission 4 (Mar. 21, 2019), https://www.sec.gov/comments/265-28/26528-5180428-183533.pdf (summarizing recent research and including relevant citations suggesting "the depth of human capital disclosure is highly associated with high performance"); Mark Huselid, The Impact of Human Resource Management Practices on Turnover, Productivity, and Corporate Financial Performance, 18 Acad. of Mgmt J. 635 (1995), http://www.markhuselid.com/pdfs/articles/1995_AMJ_HPWS_Paper.pdf (indicating that certain human capital management practices "have an economically and statistically significant impact on . . . long-term measures of corporate financial performance").

[6] We are concerned that some market participants appear to be seeking to limit certain material disclosures by labeling the matters as "ESG." In our view, materiality is materiality. Political efforts to constrain disclosure by slapping the "ESG" label on particular areas and essentially saying these are "no-go" subjects are profoundly misguided. We presume that within the human capital context, those opposed to improving disclosure may be thinking in part of risk areas such as challenges in employee recruitment deriving from discriminatory employment policies or prevalence of sexual harassment. We view these matters as clearly material. To take the latter subject, as CII discussed in a 2018 report, allegations of sexual harassment have had serious repercussions for value at a number of companies, with negative impacts on shareholders. *See* CII, How Corporate Boards Can Combat Sexual Harassment, Recommendations and Resources for Directors and Investors 2 (March 2018), https://www.cii.org/files/publications/misc/03_01_18_corporate_boards_sexual_harassment.pdf ("Allegations of sexual harassment and mishandling those allegations can clearly affect the value of a company.").

We believe that the time has come to seek ways to improve disclosure of both qualitative and quantitative elements of performance in this area. Employee turnover is an example of a measurable, comparable statistic that should be considered as a key disclosure at most or all public companies.[7]

We generally support the recent recommendations of the Investor-as-Owner Subcommittee of the Securities and Exchange Commission (SEC or Commission) Investor Advisory Committee that "as part of its ongoing disclosure review, the Commission . . . undertake a robust examination of the role HCM plays in value creation today and incorporate that analysis into the wide range of tasks the Commission performs on behalf of investors and the US capital markets."[8] As part of this, and without diminishing the need for comparable metrics, we also suggest that the SEC's Division of Corporation Finance consider whether further guidance on company disclosures in Management Discussion and Analysis should be considered to encourage management to do a better job of disclosing to shareholders management's thinking and strategy on human capital development and risks.

Environmental, Social, and Governance (ESG) Disclosure

CII's members look to public company disclosure documents for information about the full range of material risks facing registrants, including risks that may be labeled ESG.[9] A number of these risks have assumed greater importance in recent years from the perspective of investors and companies.[10] More broadly, there is a growing body of research associating various ESG factors with improved corporate performance.[11]

To our great disappointment, CII has found disclosures on various ESG risks too often consist of boilerplate risk identification without adequate discussion of how those risks apply to the

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[7] Recommendation from the Investor-as-Owner Subcommittee on Human Capital Management Disclosure at 4 (listing "company selected but standardized human capital related key performance indicators (KPIs), such as: [] the stability of the workforce, including voluntary and involuntary turnover").

[8] *Id.* at 5.

[9] *See* Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors to Brent J. Fields, Secretary, U.S. Securities and Exchange Commission 6 (July 8, 2016), https://www.sec.gov/comments/s7-06-16/s70616-49.pdf ("CII's members look to registrants' disclosure documents for information about the full range of material risks facing registrants, including environmental, social and governance ("ESG") risks.").

[10] *See, e.g.,* Governance & Accountability Institute, Inc., "FLASH REPORT: 85% of S&P 500 Index Companies Publish Sustainability Reports in 2017 (Mar. 20, 2018), https://www.ga-institute.com/press-releases/article/flash-report-85-of-sp-500-indexR-companies-publish-sustainability-reports-in-2017.html ("From 2013 to 2017, the frequency of [ESG] reporting has increased each year, **now up to 85% of companies reporting in 2017**).

[11] *See* Rebecca Moore, Investing, ESG Investments a Good Option for Retirement Plans, PLANSPONOR, Mar. 27, 2019, https://www.plansponsor.com/esg-investments-good-option-retirement-plans/ ("'a growing body of research' that suggests companies with a holistic consideration of ESG measures have better long-term fiancial outcomes and may provide more opportunities for profitable investing endeavors"); s*ee, e.g.,* Gunnar Freide et al., ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies, 5(4) J. Sustainable Fin. & Investment 210 (2015), https://www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917 (aggregating the results of about 2200 individual studies and concluding that most found positive correlations between corporate financial performance and ESG investing).

individual registrant.[12] And most registrant' disclosures relating to ESG risks provides no basis for investors to understand the scope of the risks or the likelihood of their coming to fruition.[13]

CII believes that clearer and more comparable information about key ESG risks would benefit investors and the U.S. capital markets. In that regard, we are encouraged by private sector efforts to harmonize ESG disclosures such as those of the Corporate Reporting Dialogue (CRD).[14]

It is our understanding that the CRD is designed to more closely align ESG disclosure standards among a number of competing corporate reporting frameworks.[15] We think that adoption by investors and issuers of common ESG disclosure standards would be a highly significant market improvement, but we are not yet confident this can come about through private, non-mandatory work. However, even should a voluntary approach fall short on providing comparable and reliable disclosures of key metrics, we think the work of the participants in the CRD will be important in clarifying best practice and informing eventual rule-making.

Aside from this, CII believes that as part of its routine disclosure reviews, the Commission staff should actively challenge issuers to disclose material ESG risks. That disclosure should, at a minimum, be sufficiently detailed to provide insights as to how management plans to mitigate risks relating to ESG issues, and how associated decisions could be material to a company's business or their investors.[16]

CII would expect that with more rigorous SEC staff oversight, issuer disclosures about climate related risks would be more robust. We believe the 2010 SEC guidance on disclosure relating to climate change[17] was helpful, and note recent industry comments that those requirements are clear.[18] And we commend William Hinman, the Director of the SEC's Division of Corporation

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[12] Letter from Kenneth A. Bertsch at 7.

[13] *Id.*

[14] Press Release, CDSB, Leading Corporate Reporting Bodies Launch Two-Year Project for Better Alignment (Nov. 7, 2018), https://www.cdsb.net/harmonization/860/leading-corporate-reporting-bodies-launch-two-year-project-better-alignment ("Through this new project, participants will map their respective sustainability standards and frameworks to identify the commonalities and differences between them, jointly refining and continuously improving overlapping disclosures and data points to achieve better alignment, taking into account the different focuses, audiences and governance procedures.").

[15] *Id.* ("The Corporate Reporting Dialogue was launched four years ago as the principal working mechanism globally to achieve dialogue and alignment between the key standard setters and framework developers which have significant international influence on the corporate reporting landscape.").

[16] *See* William Hinman, Director, Division of Corporation Finance, Remarks at the 18th Annual Institute on Securities Regulation In Europe (Mar. 15, 2019), https://www.sec.gov/news/speech/hinman-applying-principles-based-approach-disclosure-031519 ("And as they do so I would suggest they ask themselves whether their disclosure is sufficiently detailed to provide insight as to how management plans to mitigate material risks and how their decisions in the area of risk could be material to the business and their investors.").

[17] Commission Guidance Regarding Disclosure Related to Climate Change, Securities Act Release No. 9,106, Exchange Act Release No. 61,469, 75 Fed. Reg. 6,290 (Feb. 8, 2010), https://www.govinfo.gov/content/pkg/FR-2010-02-08/pdf/2010-2602.pdf.

[18] Climate-Related Risks, SEC Has Taken Steps to Clarify Disclosure Requirements 25 (GAO Feb. 2018), https://www.gao.gov/products/GAO-18-188 ("representatives from five industry associations with whom we spoke all noted that they consider the current requirements for climate-related disclosures adequate"); *but see, e.g.*, Christian Weller, Workers Face Undisclosed Risks As Companies Often Don't Disclose Environmental, Other Challenges, Forbes (Apr. 2, 2019), https://www.forbes.com/sites/christianweller/2019/04/02/workers-face-savings-risks-as-companies-often-dont-disclose-environmental-other-challenges/#1bba802e7d9f (commenting that climate

Finance, for recently reminding issuers that the 2010 SEC guidance "remains a relevant and useful tool for companies when evaluating their disclosure obligations concerning climate change matters."[19] However, we are unsure of the extent to which this guidance is reflected in SEC comment letters to companies on relevant disclosures.[20]

Shareholder Proposals and Proxy Advisors

In our December 5, 2018, letter to the Committee on Banking, Housing and Urban Affairs (Committee), CII provided detailed comments on the appropriateness of the current shareholder proposal rule and regulations pertaining to proxy advisory firms.[21] On shareholder proposals, we noted that: "We generally share the reported view of certain SEC staff members that left the roundtable with the impression that stronger arguments were made in favor of keeping the current Rule 14a–8 eligibility requirements and resubmission thresholds."[22]

While CII recognizes that the existing ownership and resubmission thresholds were set long ago, we continue "to believe the current shareholder proposal rules permit investors to express their voices collectively on issues of concern to them, without the cost and disruption of waging proxy contests."[23] And we continue to "believe the rule works particularly well in granting retail investors—who lack other avenues to meaningfully engage with management—a voice in the companies they own."[24]

CII believes that the Committee Ranking Member fairly summarized the current debate surrounding shareholder proposals in his opening statement at the April 2nd hearing [Hearing]: "Corporate special interests want to . . . silence the voices of . . . investors by making it harder for shareholders to petition companies to allow all shareholders to vote on issues significant to the company."[25]

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change guidance "left a lot of room for managers to either not disclose anything or to disclose little new or relevant information").

[19] William Hinman, Director, Division of Corporation Finance, Remarks at the 18th Annual Institute on Securities Regulation In Europe.

[20] *See* Alexandra Semenova, News, SEC Stops Prodding Companies to Detail Climate Change Impacts, BNA, July 16, 2018, https://www.bna.com/sec-stops-prodding-n73014477478/ ("The Securities and Exchange Commission last issued a climate change-related public comment letter in September 2016, when it asked Chevron Corp. to expand its risk factor disclosure related to California's greenhouse gas emission regulations.").

[21] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to The Honorable Michael Crapo, Chairman, Senate Committee on Banking, Housing, and Urban Affairs et al. 1-8 (Dec. 5, 2018) [hereinafter December Letter], https://www.cii.org/files/issues_and_advocacy/correspondence/2018/December.%205%202018%20Letter%20to%20Senate%20Banking.pdf.

[22] *Id.* at 8 (internal quotations omitted).

[23] Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to The Honorable Michael D. Crapo, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate et al. 12 (Feb. 27, 2019) [hereinafter February Letter], https://www.cii.org/files/issues_and_advocacy/correspondence/2019/February%2027%202019%20Letter%20to%20Senate%20Banking%20Committee.pdf.

[24] *Id.*

[25] Transcript of Senate Banking, Housing and Urban Affairs Committee, Hearing on The Application of Environmental, Social, and Governance Principles in Investing and the Role of Asset Managers, Proxy Advisors, and Other Intermediaries, Bloomberg Gov't 5 (Apr. 3, 2019) (on file with CII).

As we suggested above, the attempt to rule certain matters significant to companies and their shareholders as "out of bounds" because they have social and/or political dimensions, or because there are differing views on them, seems perverse. Ironically, these efforts to exclude "politics" are themselves highly political efforts to limit discussion, and we would expect shareholder proposals to highlight matters on which there is some measure of disagreement. Typically, shareholder proposals are not required on matters for which the best path is obvious and universally agreed.

In this regard, we would note that shareholder proposals are a key tool in the U.S. market not only to communicate to the board and management, but also to other shareholders. For antitrust and other reasons, it is very difficult for shareholders in the U.S. market to communicate on company-specific matters with each other, putting a premium on the shareholder proposal as a tool both to express the collective voice of shareholders and for investors to gain some understanding of the perspective of other investors. We think this aspect of utility in shareholder proposals is entirely lost on management-oriented groups that would like to confine all company/shareholder engagement to one-on-one communications.

On proxy advisory firms, we highlighted in our December 5 letter that: "Notably, at the end of the Roundtable when the SEC staff asked if proxy advisory firms need additional regulation, no panelist—including those speaking on behalf of the corporate community . . . —voiced any need for new regulations."[26] One of those panelists was Patti Brammer, Corporate Governance Officer, Ohio Public Employees Retirement System (OPERS). Consistent with her comments at the Roundtable, a follow-up letter to the SEC explained:

> *OPERS does not believe additional regulation of proxy advisory firms is warranted.* If however, the SEC believes that some intervention is necessary, we urge the Commission to carefully consider the consequences of any potential changes, particularly for the investors that depend on the information provided by proxy advisory firms. To the extent that a regulatory change increases our costs, delays the information we need, or erodes the confidence we have in the independence of the research reports we receive, there will be a negative impact on our members – the law enforcement officers, university employees, librarians, road workers, and others who depend on us for their retirement security. We respectfully request that the SEC preserve our access to efficient, timely, and independent information from our proxy advisory firm.[27]

Another of those panelists was former Committee Chairman Senator Phil Gramm. Our members and most market participants share the following view expressed by Senator Gramm at the

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[26] December Letter, *supra* note 21, at 3-4; *see generally* Matt Egan, Corporate America Loves Deregulation. Then Why Is It Pushing For These Rules?, CNN Bus., Mar. 29, 2019, https://www.cnn.com/2019/03/29/investing/regulation-proxy-advisory-reform-sec/index.html (commenting that some "say business groups are going after proxy advisers to silence shareholders by cutting them off from rigorous research needed to scrutinize gaudy pay packages and evaluate complicated proposals on topics such as climate change and minimum wage hikes").

[27] Letter from Karen Carraher, Executive Director, Ohio Public Employees Retirement System et al. to Brent J. Fields, Secretary, Securities and Exchange Commission 4 (Dec. 13, 2018), https://www.sec.gov/comments/4-725/4725-4767821-176841.pdf.

Hearing: "[M]y dealings with proxy advisors basically have been good. I think they listen [and] . . . the problem is not proxy advisors."[28]

CII also notes that in a post-Roundtable letter to the SEC, T. Rowe Price Associates, Inc. stated: "We . . . would have significant concerns with any regulatory changes that would sacrifice the objectivity of proxy advisor reports or introduce delays in the proxy voting process that, in an already compressed and intensely seasonal voting cycle, could result in missed vote deadlines."[29]

We acknowledge that SEC Commissioner Elad L. Roisman and some others have raised some legitimate issues regarding conflicts of interest, accuracy and completeness, pre-populating votes, and overly standardized voting guidelines.[30] While we concede that there is room for improvement, we believe there are other more cost-effective avenues for improvements to proxy advisory firms that do not require additional regulation.

CII believes that the Commission could encourage private sector solutions. In particular, we support strengthening of the Best Practice Principles for Shareholder Voting Research, a global proxy advisory industry effort to improve standards.[31] We also note that Glass Lewis (GL) recently announced that they have established a Report Feedback Statement (RFS).[32] In response to concerns about accuracy and completeness of information, the RFS provides an opportunity for public companies and shareholder proposal proponents to express their differences of opinion with GL analysis, and then have those comments delivered to 3000+ individuals who subscribe to GL's research and voting services.[33]

In addition, CII believes the Commission could consider improving the enforcement of its existing guidance. SEC Staff Legal Bulletin No. 20 (SLB 20), in our estimation, already appropriately requires investment advisors to ensure that voting recommendations are based on current and accurate information and to identify and address conflicts of interest.[34] If the SEC has evidence that the provisions of SLB 20 regarding proxy advisory firms are not being complied with or are

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[28] Transcript of Senate Banking, Housing and Urban Affairs Committee, hearing on The Application of Environmental, Social, and Governance Principles in Investing and the Role of Asset Managers, Proxy Advisors, and Other Intermediaries, Bloomberg Gov't at 14.

[29] Letter from Donna F. Anderson, Head of Corporate Governance, T. Rowe Price Associates, Inc. et al. to Brent J. Fields, Esq., Secretary, Securities and Exchange Commission 3 (Dec. 13, 2018), https://www.sec.gov/comments/4-725/4-725.htm.

[30] *See, e.g.,* Commissioner Elad L. Roisman, Keynote Remarks: ICI Mutual Benefit Funds and Investment Management Conference (Mar. 18, 2019), https://www.sec.gov/news/speech/speech-roisman-031819.

[31] *See* The BPPG, Best Practices Principles for Shareholder Voting Research (last visited Apr. 8, 2019), https://bppgrp.info/.

[32] Katherine Rabin, CEO, Glass Lewis, Glass Lewis' Report FeedBack Service: Direct, Unfiltered Commentary from Issuers and Shareholder Proponents, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Mar. 31, 2019), https://corpgov.law.harvard.edu/2019/03/31/glass-lewis-report-feedback-service-direct-unfiltered-commentary-from-issuers-and-shareholder-proponents/.

[33] *Id.* at 2 ("The Report Feedback Statement service provides a unique opportunity for public companies and shareholder proposal proponents—the subjects of Glass Lewis research—to express their differences of opinion with Glass Lewis' analysis, and then have those comments delivered through a unique, focused channel to 3,000+ individuals who subscribe to Glass Lewis' research and voting services.").

[34] *See, e.g.,* February Letter, *supra* note 23, at 13 ("While we concede that there is room for improvement, SEC Staff Legal Bulletin No. 20, in our estimation, already effectively requires investment advisors to ensure that voting recommendations are based on current and accurate information and to identify and address conflicts of interest.").

otherwise misunderstood by investment advisors, we would support more effective SEC oversight and enforcement of the guidance and, if deemed necessary, clarification of the requirements.

Finally, the most critical point contained in our most recent letter to the Committee on the proxy process bears repeating. In our view, by far the most cost-effective proxy related issue that the SEC should devote its limited resources to, that would benefit capital formation and long-term shareowner value, and that is supported by most issuers and investors, is *modernizing the proxy voting infrastructure using new technologies.*[35] We respectfully request that the Committee focus its important oversight role of the SEC's proxy process project on this critical issue and the related interim improvements of vote confirmation and universal proxy.[36]

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If we can answer any questions or provide additional information that would be helpful to you or the Committee, please do not hesitate to contact me at 202.822.0800 or jeff@cii.org.

Sincerely,

Jeffrey P. Mahoney
General Counsel

[35] *See id.* at 10 ("Technological change now offers the opportunity to construct a better system with the potential to fix a panoply of problems associated with proxy voting"); *see also* Andrea Vittorio et al., Regulating ISS, Proxy Advisors is on SEC's Radar Under Roisman, Mar. 12, 2019, https://news.bloomberglaw.com/corporate-law/regulating-iss-proxy-advisers-is-on-secs-radar-under-roisman (Quoting a "former SEC official . . . [that proxy plumbing] 'is one of the more important things to get done'").

[36] *See, e.g.,* February Letter, *supra* note 23, at 10-12 (discussion of proxy process project longer term and interim improvements).

LETTERS SUBMITTED BY THE NATIONAL ASSOCIATION OF MANUFACTURERS

Chris Netram

Vice President,
Tax and Domestic Economic Policy

April 2, 2019

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown,

On behalf of the National Association of Manufacturers (NAM), I want to thank you for holding today's hearing on *The Application of Environmental, Social, and Governance Principles in Investing and the Role of Asset Managers, Proxy Advisors, and Other Intermediaries*.

Manufacturers look to the public market to finance pro-growth activities like business expansion and job creation, which in turn set the stage for economic expansion right here in America. At the same time, manufacturing workers – 67 percent of whom participate in a workplace retirement plan – depend on the public market to invest for the future. A well-calibrated proxy process is key to ensuring effective shareholder engagement and enhancing returns for manufacturing employees and investors alike.

In recent years, manufacturers and their shareholders have experienced increased intrusions into the proxy process from third parties that have little-to-no stake in a company's success. Manufacturers now must contend with activists pursing agendas disconnected from long-term value creation and proxy advisory firms seeking to institute one-size-fits-all standards through their conflicted, error-filled voting recommendations. Today's hearing offers the Banking Committee an important opportunity to consider the outsized influence that these market actors have on the corporate governance policies of U.S. public companies and the risk they pose to the life savings of millions of Main Street investors.

As you know, the SEC is also considering how best to ensure that the proxy process allows companies to focus on generating long-term returns for their shareholders. The NAM recently submitted a comment letter to the SEC as a follow-up to its November 15, 2018, proxy roundtable urging the Commission to take steps toward concrete reforms that would provide for effective oversight of proxy firms and enhance the quality of information available to investors. I have attached this letter for the record, as we believe it could provide useful insights to the Committee as you continue your important work to improve the proxy process.

* * * *

On behalf of the 12 million men and women who make things in America, thank you for your continued attention to these important issues.

Sincerely,

Chris Netram
Vice President, Tax & Domestic Economic Policy

Chris Netram

Vice President,
Tax and Domestic Economic Policy

March 5, 2019

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File No. 4-725: *SEC Staff Roundtable on the Proxy Process*

Dear Mr. Fields,

The National Association of Manufacturers (NAM) appreciates the opportunity to provide comments to the Securities and Exchange Commission (SEC) as a follow-up to its November 15, 2018, roundtable on the proxy process. We urge the Commission to build on the robust discussion of proxy advisory firms at the roundtable and take steps toward concrete reforms that would provide for effective SEC oversight of proxy firms and enhance the quality of information available to investors.

Manufacturers often turn to the capital markets to finance pro-growth activities like business expansion and job creation, which in turn set the stage for economic expansion right here in America. At the same time, manufacturing workers – 67 percent of whom participate in a workplace retirement plan[1] – depend on the public market to invest for the future. NAM members and their employees are significantly impacted by the outsized role that proxy advisory firms play in America's capital markets.

The NAM submitted a comment letter on October 30, 2018, in advance of the November roundtable[2]; as we said in that letter, proxy advisory firms "have enormous influence over the corporate governance policies of U.S. public companies – decisions that impact the direction of a business and the life savings of millions of Main Street investors." The NAM has no objection to proxy firms providing information to the marketplace; however, advice that is tainted by undisclosed conflicts of interest, errors, one-size-fits-all decision-making, and a lack of transparency imposes significant costs on manufacturers and manufacturing workers. We appreciate the SEC's continued attention to this vital issue, and we encourage the Commission to consider the following reforms to better regulate the role that proxy advisory firms play in the marketplace and provide more effective oversight of their business.

I. Amend or Supplement Release No. IA-2106 to Clarify Investment Advisers' Obligations Under Rule 206(4)-6

SEC Rule 206(4)-6 requires that investment advisers adopt policies and procedures to ensure that they are making proxy voting decisions in their clients' best interests. A key concern in making this determination is how the adviser addresses any material conflicts that may divide their interests from

[1] *National Compensation Survey: Employee Benefits*. Bureau of Labor Statistics, March 2018. https://www.bls.gov/ncs/ebs/benefits/2018/ownership/private/table02a.pdf.

[2] https://www.sec.gov/comments/4-725/4725-4581799-176285.pdf.

those of their clients. Guidance in Release No. IA-2106 allows advisers to cleanse themselves of any potential conflicts of interest by relying on the voting recommendations of an "independent third party." Though IA-2106 notes that the effectiveness of policies and procedures designed to mitigate potential conflicts "will turn on how well they insulate the decision on how to vote client proxies from the conflict," many investment advisers nonetheless rely on proxy advisory firms that have substantial conflicts themselves. More clarity is needed on the guardrails around how investment advisers can utilize independent third parties in order to ensure that proxy voting decisions are made in the best interests of the middle-class Americans whose retirement accounts are at stake.

Reinforce Investment Advisers' Fiduciary Duty When Utilizing Proxy Firm Recommendations

Most importantly, the SEC should clarify that reliance upon the recommendation of an independent third party is not sufficient, in and of itself, to avoid conflicts of interest and/or to fulfill an investment adviser's fiduciary duty to its clients. Utilizing a third party may be one of the steps an adviser takes to avoid conflicts, but the ultimate evaluation as to whether a conflict arises (and thus whether an adviser's fiduciary duty has been fulfilled) must be undertaken on an issuer-by-issuer and issue-by-issue basis. Reliance on a proxy firm that is itself conflicted would simply trade the adviser's potential conflicts for the firm's and thus not be effective in protecting an investor's interests. Expanding the conflicts of interest language in Section II(A)(2)(b) of IA-2106 to clarify that an independent third party is not necessary to fulfill an investment adviser's fiduciary duty, nor is it sufficient to do so absent complementary analysis that shows an issue-specific decision was made in the investor's best interest, would provide more effective guidelines to investment advisers as they design their internal policies and procedures to avoid conflicts.

The SEC could also mandate that investment advisers relying on proxy advisory firms' recommendations contractually require that the firms live up to the same fiduciary duty standard to which the advisers themselves are held. Such a step would ensure that all parties involved in deciding how an investor's shares should be voted are guided by that investor's best interests. It would also make clear to investors that their needs are the driving force behind decisions made with their money, as well as allow for effective oversight of proxy firms' decision-making processes under the applied fiduciary duty standard.

It is important to note that the NAM does not believe that prohibitions on investment advisers' use of proxy advisory firms or other third parties are necessary. Indeed, the institutional investors participating in the November roundtable made clear that proxy firm research is a vital facet of their decision-making process – and quality, conflict-free external advice that enables investment advisers to act in the best interests of their clients can only benefit Main Street investors. Manufacturers simply believe that investment advisers have a duty to ensure that the research and recommendations on which they rely actually help them avoid conflicted votes rather than introducing new conflicts.

Clarify the Definition of "Independent Third Party"

Within the framework of IA-2106, the SEC could also build out the definition of "independent third party" in order to give investment advisers better tests of a proxy firm's independence. Clearer guardrails would enable investment advisers to make a more informed choice about whether and how to utilize a third party; these tests would also incentivize proxy advisory firms to make targeted reforms to their business model in order to maintain their investment adviser client base. For example, qualification as "independent" under IA-2106 could hinge on, among other things:

- Avoidance of conflicts of interest relevant to a given issuer or issue and appropriate mitigation of any conflicts that arise;
- Public disclosure of any conflicts of interest as well as clear communication of issuer- and issue-specific conflicts directly to the investment adviser; and

- Delivery of issuer- and issue-specific recommendations rather than a reliance on one-size-fits-all guidelines.

Alternatively, the SEC could consider removing mention of independent third parties from IA-2106 entirely. Such a modification would in no way prohibit investment advisers from engaging the services of a proxy firm (or other third party), nor would it prevent reliance on a third party from being one of the many potential policies and procedures that advisers could adopt in order to attempt to avoid conflicted voting decisions. It would, however, undercut the flawed presumption that conflict mitigation is a *de facto* offshoot of the investment adviser-proxy firm relationship – instead making clear that the decision to utilize a proxy firm to guide proxy votes would be subject to the same effectiveness test as any other conflict mitigation strategy.

Improve Disclosure of Policies and Procedures Related to Third Party Influence

In the event that an investment adviser utilizes a third party to help shape an investor's proxy votes, the adviser should take proactive steps to ensure that their clients have access to information that will allow them to fully understand the policies and procedures that led to any final voting decision. Rule 206(4)-6 requires that investment advisers "[d]escribe to clients [their] proxy voting policies and procedures;" expanding on this requirement, especially as it relates to reliance on third parties, would help prioritize investment advisers' fiduciary duty in their choice of proxy advisory firms and ensure that one-size-fits-all guidelines do not overtake well-reasoned, issue-specific voting decisions.

For example, many market participants have made clear that the voting infrastructure offered by the proxy firms is an invaluable client service. The NAM in no way wants to interfere with institutional investors' ability to utilize that infrastructure, but we do believe that institutions should disclose to their clients if and how they review their ballots before they are auto-cast by the proxy firms.

More generally, advisers should disclose what policies are in place to ensure that investors' best interests are represented throughout the decision-making process. For example, advisers should disclose whether the proxy firms on which they rely gave issuers sufficient time to review and respond to draft recommendations and, if not, why they are relying on a recommendation that could contain errors or misconceptions. Similarly, investment advisers should be required to disclose their "custom" voting policies to their clients, as well as to what extent their final votes aligned with proxy firm recommendations, so that investors can evaluate the degree to which a proxy firm's one-size-fits-all guidelines are being applied to their holdings. These sorts of disclosures would help investors better understand the relationship between investment advisers' fiduciary duty and the proxy firms' voting recommendations, as well as allow them to evaluate for themselves how effectively their votes are being cast.

Make Clear That Investment Advisers Are Not Required to Vote Every Proxy

In IA-2106, the Commission notes that it is *not* the case "that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations," and, further, that "[t]here may even be times when refraining from voting a proxy is in the client's best interest." Similarly, Staff Legal Bulletin No. 20 (SLB 20) envisages "proxy voting arrangements in which the adviser would not assume all of the proxy voting authority," including instances where expending the time and resources to vote a proxy would not be in the client's best interest, agreements between client and adviser that the adviser will abstain from voting on all proxies or on certain types of proposals, and arrangements where the adviser always votes in favor of management or a particular shareholder proponent.

Despite this seemingly clear guidance, investment advisers nonetheless often feel pressure to vote on every issue in every proxy contest. This gives rise to a paradigm wherein many advisers institute

policies to vote every proxy despite a lack of internal resources or expertise necessary to fully evaluate each voting decision on a company-by-company basis. This may have been exacerbated, to some extent, by the 2004 no-action letters issued to ISS and Egan-Jones – which the SEC has now withdrawn.

The pressure to focus on ballot measures that do not impact long-term value creation for investors can distract advisers from the issues most important to investor returns and stretch their internal resources – forcing them to rely more heavily on proxy advisory firms. This increases costs and exacerbates issues with proxy firms by creating more opportunities for their inaccurate and conflicted recommendations to impact shareholders, despite the fact that SEC guidance has made clear that advisers do not have to vote every proxy in the first place. Any amendments to IA-2106 should continue to emphasize that investment advisers are always required to act in a client's best interests, including in situations where choosing not to exercise their proxy voting authority is the best choice for an investor.

II. Replace the 2004 ISS and Egan-Jones No-Action Letters With Guidance That Effectively Enforces Staff Legal Bulletin 20

As we said in our October 30, 2018, comment letter in advance of the proxy roundtable, the no-action letters issued to ISS and Egan-Jones in 2004 largely allowed investment advisers to outsource their decision-making and voting power to the proxy advisory firms. Specifically, we noted that the no-action letters enabled investment advisers to ignore the firms' significant conflicts of interest even as they took steps to utilize the firms to mitigate their own conflicts and, more generally, entrenched proxy firms' place in the market and allowed their one-size-fits-all, non-transparent approach to corporate governance to flourish. As such, we called the SEC staff's decision to withdraw the no-action letters "an important first step toward restoring the primacy of a fund manager's fiduciary duty to protect investors' retirement savings."

As the SEC considers how best to replace the now-withdrawn no-action letters, the NAM encourages the Commission to look for ways to undergird SLB 20, which provides guidance on investment advisers' responsibilities in voting client proxies and utilizing proxy advisory firms. Though SLB 20 did not take the step of withdrawing or overriding the 2004 no-action letters when it was released in 2014, its guidance should prove useful for investment advisers considering proxy firms' impact on their voting decisions now that the letters have been withdrawn – especially if the key facets of SLB 20 are supported by additional rulemaking. For example, under SLB 20 investment advisers retaining a proxy firm are required to:

- "Ascertain, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues;"
- "Consider…the robustness of [the proxy advisory firm's] policies and procedures regarding its ability to (i) ensure that its proxy voting recommendations are based on current and accurate information and (ii) identify and address any conflicts of interest;"
- "Adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the [proxy advisory firm] in order to ensure that the investment adviser, acting through the [proxy advisory firm], continues to vote proxies in the best interests of its clients;"
- "Establish and implement measures reasonably designed to identify and address the proxy advisory firm's conflicts that can arise on an ongoing basis;" and
- In the event of a material factual error impacting a recommendation, "take reasonable steps to investigate the error…and seek to determine whether the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future."

Additional guidance or rulemaking underscoring these requirements would make clear that investment advisers have a substantial due diligence requirement when utilizing a proxy firm's

research and recommendations and underscore the need for reform on the part of the firms in order to meet these standards. Guidance or rulemaking could also clarify how the Commission plans to hold advisers to these standards going forward, as well as what options might be available for the adviser's clients to ensure that the due diligence requirements are upheld with regard to their investments.

The NAM believes that advisers could comply with SLB 20's requirement that they "identify and address the proxy advisory firm's conflicts" by verifying, on a case-by-case basis, that any given proxy firm recommendation is not poisoned by the firm's conflicts of interest. Similarly, we believe that investment advisers could require that proxy firms give issuers sufficient time to review and respond to draft recommendations in order to ensure they are "continu[ing] to vote proxies in the best interest of [their] clients" under SLB 20 – after all, a process that allows issuers to identify mistakes and provide alternate perspectives can only improve the quality of the final vote decision. Advisers could also, per the requirements to ascertain competency and to investigate errors, require that the firms take steps to confirm that they are not negligent in consistently making errors and misrepresenting company proposals – especially since a recent study found that there were 139 instances of factual errors, analytical errors, or serious disputes reported in supplemental proxy statements over the last three years alone.[3]

We also believe, as outlined in our previous comment letter, that a process that allows investment advisers to fulsomely evaluate proxy firm recommendations that have been contested by an issuer would support compliance with SLB 20. Such a process would allow for an issuer to respond to the recommendation and include their dissenting opinion in the proxy firm materials alongside the recommendation and an explanation of any significant errors or departures in methodology. In such a situation, an investment adviser would not fulfill its fiduciary duty to investors if it relies on a pre-existing automatic voting policy with the proxy firm; instead, it would be required to substantively evaluate the discrepancy between the firm's recommendation and the issuer's point of view and make an affirmative decision in the best interest of the investors whose funds it manages.

It is apparent that the market would benefit from clarity in the wake of the withdrawal of the ISS and Egan-Jones no-action letters. The SEC now has the opportunity to take steps to provide effective guidance around the requirements of SLB 20 in order to set clear guardrails for the investment adviser-proxy firm relationship and foreground both parties' obligation to enhance long-term shareholder value for Main Street investors.

III. Amend the Exemptions to the Proxy Solicitation Rules to Require Reforms on the Part of Proxy Advisory Firms

Proxy advisory firms rely on the SEC Rule 14a-2(b) exemptions from the proxy solicitation rules to avoid the Schedule 14A regulatory regime. Specifically, the firms qualify for an exemption under Rule 14a-2(b)(3), which states that the proxy solicitation rules do not apply to "[t]he furnishing of proxy voting advice" provided certain standards are met. The NAM supports clarifying and expanding the restrictions under Rule 14a-2(b) to ensure that proxy advisory firms furnish advice to institutional investors that is developed with the best interests of Main Street investors in mind.

Though the firms rely on the Rule 14a-2(b)(3) exemption, they nevertheless claim that such reliance is not technically necessary for them to avoid Schedule 14A because they are "contractually obligated" to provide their recommendations. Notably, ISS's letter to the Senate Banking Committee dated May 30, 2018, contends that providing proxy voting advice to clients does not constitute a solicitation in the first place, despite guidance to the contrary in SLB 20. This argument is

[3] Placenti, Frank M., *Are Proxy Advisors Really A Problem?* October 2018. http://accfcorpgov.org/wp-content/uploads/2018/10/ACCF_ProxyProblemReport_FINAL.pdf.

disconnected from the fact that proxy firm analysis has become an integral part of the regulated solicitation process, as well as the safe harbors the SEC has previously recognized for investment advisers' reliance on the firms' "independent" analysis. SEC clarification that the furnishing of proxy voting advice as practiced by proxy firms does indeed qualify as proxy solicitation – thus necessitating a reliance on an exemption – is clearly needed to rectify this misperception.

Furthermore, though the firms' contractually obligated voting recommendations are clearly solicitations, none of the Rule 14a-2(b) exemptions were specifically designed with proxy firms in mind, including the exemptions discussed in SLB 20. Given the firms' need to rely on an exemption, modifications to Rule 14a-2(b) to specifically cover contractually obligated solicitations would ensure the exemptions are working properly.

Amendments to the proxy solicitation exemptions should address the key structural flaws endemic to the proxy firms' business model – namely, their one-size-fits-all policies, lack of transparency, propensity for errors, misleading assumptions about key benchmarks like peer groups, lack of dialogue with issuers, problematic robo-voting policies, and significant conflicts of interest. The SEC should amend Rule 14a-2(b)(3) (or create a new exemption) to provide an exclusive safe harbor for contractually obligated solicitations. Any such safe harbor should condition proxy firms' reliance upon the exemption on the following requirements:

- Proxy firms should allow all issuers, not just the largest companies, access to draft recommendations. Currently, one of the two leading firms only provides draft reports to companies in the S&P 500, while the other charges issuers a fee to review recommendations; going forward, productive engagement with all issuers should be the norm.

- Proxy firms should give issuers sufficient time to review draft recommendations. A review period of at least five business days would provide for enough time for companies to spot mistakes, correct misunderstandings, and proactively engage with their investors.

- Proxy firm reports should include an issuer's dissenting opinion explaining the reasoning behind management's preferred course of action and/or highlighting errors in the firm's report in the event a recommendation is contested. Proxy firms would be under no obligation to modify any recommendation; the dissenting opinion would simply give investors additional information from the company's perspective.

- Proxy firms should be required to justify any significant departures in methodology (*e.g.*, differences in determining peer group, disclosed compensation, or other key business metrics) that lead to discrepancies between the firm's understanding of an issue and the company's stance, as well as explain the reasoning for the application of any one-size-fits-all guidelines that may not be appropriate to evaluate a given issuer.

- Proxy firms should be required to publicly disclose any conflicts of interest to make clear to the entire marketplace the incentive structure underlying the firms' recommendations on any given issuer. This public disclosure would be complemented by individual conflicts disclosures (related to specific issuers or individual ballot measures) on the proxy reports disseminated to investment advisers.

- Proxy firms should disable any default vote settings in the event that a recommendation is contested by an issuer. This would prevent automatic votes on contentious issues (while smoothing the process on non-contested issues) and instead allow an investment adviser time to make a considered decision by weighing the relative merits of the firm's recommendation and a company's dissenting opinion. Once an affirmative decision is

reached, the adviser could confirm the choice with the proxy firm and the vote would be cast accordingly.

Providing an exclusive safe harbor by making these commonsense reforms to Rule 14a-2(b)(3) (or by providing for a new exemption under Rule 14a-2(b)) would incentivize the proxy advisory firms to make the internal changes necessary to improve accuracy, enhance transparency, and address conflicts of interest. Furthermore, such a safe harbor would provide clear guidance to investment advisers relying on proxy firms as "independent" third parties under IA-2106 as to the standards to which the firms should be held. Ultimately, clarifying and expanding Rule 14a-2(b) would lead to significant improvements in the breadth and quality of information available to investment advisers and ensure that the advisers and the firms both clearly understand the regulatory paradigm in which the firms operate.

IV. Require Proxy Advisory Firms to Register With the SEC

The NAM believes that the SEC can make significant progress toward effective oversight of proxy advisory firms via the targeted reforms to the existing regulatory regime discussed above. However, the Commission also has the statutory authority to consider a more direct approach to proxy firm reform: registration with the Commission, as envisioned by the Corporate Governance Reform and Transparency Act. Requiring proxy advisory firms to register with the SEC would allow the Commission to set metrics related to conflict mitigation, transparency, responsiveness, and accuracy and make registration contingent upon a proxy firm's compliance with the published standards. As the SEC contemplates how best to make reforms that reduce proxy firms' outsized influence and emphasize all market actors' fiduciary duty to America's Main Street investors, it should continue to give careful consideration to all policy solutions it has the authority to implement – including a registration regime.

* * * *

The NAM applauds the SEC for considering the role that proxy advisory firms play in America's capital markets and how targeted reforms and effective oversight can reduce the firms' influence and reinforce investment advisers' fiduciary duty to Main Street investors. We encourage the SEC to take concrete action to address these issues, and we look forward to working with you to ensure that America's public markets continue to support the growth of manufacturers in all 50 states.

On behalf of the NAM and the 12 million men and women that make things in America, thank you for your attention to these concerns.

Sincerely,

Chris Netram
Vice President, Tax & Domestic Economic Policy

LETTER SUBMITTED BY SOCIETY FOR CORPORATE GOVERNANCE

SOCIETY
for Corporate Governance

April 19, 2019

The Honorable Senator Mike Crapo
Chairman
U.S. Senate Committee on
Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Senator Sherrod Brown
Ranking Member
U.S. Senate Committee on
Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the Society for Corporate Governance, we thank the U.S. Senate Banking Committee for considering the important issue of proxy advisory reform. In November 2018, a strongly bipartisan group of Senators, including Senator Jack Reed, Senator David Perdue, Senator Thom Tillis, Senator Doug Jones, Senator John Kennedy and former Senator Heidi Heitcamp, introduced S.3614, The Corporate Governance Fairness Act of 2018 (the "CGFA"), to advance the regulation of proxy advisory firms by the SEC. We are hopeful that this legislation will be reintroduced in the 116th Congress. This legislation strengthens our capital markets and protects investors by addressing proxy advisor firm conflicts of interest, improving transparency and providing basic due process to public companies that will improve the accuracy of information provided to investors. The CGFA will improve investor access to accurate and unbiased information by requiring entities that meet the definition of a "proxy advisory firm" to register with the SEC under the Investment Advisers Act of 1940. It also directs the SEC to complete a targeted examination of the proxy advisory firms' communications to their clients, and policies and practices related to their management of conflicts of interest. Finally, the legislation requires the SEC to consult with all relevant stakeholders and produce a report to the Congress that reviews the same issues mandated by the targeted examination, and outlines whether the SEC should consider additional protections related to proxy advisory firms.

We urge support of the CGFA.

Background

Founded in 1946, the Society is a professional membership association of more than 3,700 corporate and assistant secretaries, in-house counsel, outside counsel and other governance professionals who serve approximately 1,700 entities, including 1,000 public companies of almost every size and industry. Society members are responsible for supporting the work of corporate boards of directors and the executive managements of their companies on corporate governance and disclosure matters.[1]

[1] A more complete articulation of the Society's concerns regarding proxy advisory firms can be found in the Society's comment letter filed in connection with the SEC's Proxy Process Roundtable in November, 2018: https://www.sec.gov/comments/4-725/4725-4640411-176449.pdf

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While there are five primary proxy advisory firms in the U.S., today the market is essentially a duopoly consisting of Institutional Shareholder Services ("ISS"), owned by private equity firm Genstar, and Glass Lewis & Co. ("Glass Lewis"), a portfolio company of the Ontario Teachers' Pension Plan Board. The voting recommendations made by these proxy advisory firms are the single most influential pronouncements each year on the composition of a public company's board, its executive compensation policies, and an increasingly diverse range of shareholder proposals.

Proxy advisory firms are one of the few participants in the proxy voting process that are not generally required to be registered or regulated by the SEC. Proxy statements are subject to regulation under the Securities Exchange Act of 1934 (including liability thereunder for misstatements or omissions); proxy advisory firm reports, however, are not. Yet, many institutional investors rely upon them just as heavily, if not more so, in making voting and investment decisions. There is little accountability by proxy advisory firms despite having an outsized impact on critical governance matters at widely held companies.

The Society's concerns regarding proxy advisory firms fall into three categories: conflicts of interest, transparency and due process.

Conflicts of Interest

ISS, the largest proxy advisory firm, has a foundational conflict of interest—it provides clients with voting recommendations on a company's corporate governance and compensation policies and also seeks to be hired by these same companies to provide paid corporate governance and/or compensation consulting services.

Society members have reported being contacted by ISS' corporate consulting sales force suggesting that they have a unique ability to help fix any problems that the company has had with a previous vote if they hire ISS for a consulting engagement. And in these conversations with the sales force, companies are offered a tiered service level where more ISS involvement and insights come at a higher price. In addition, ISS now offers an environmental and social scorecard consulting service, for an added cost.

A conflict of interest applicable to all proxy advisors is that such firms provide voting recommendations on shareholder proposals that may have been submitted by their institutional investor clients without disclosing that such a conflict exists. Further, ISS has a paid service for shareholder proponents to help them craft proposals that will pass muster under SEC rules. In addition, proxy advisors also sell data and other analytical tools to institutional investors and hedge funds[2], and then simultaneously recommend votes on all matters, including these same hedge funds' proxy contests.

These conflicts should be subject to regulation that would require specific and prominent disclosure to institutional investor clients in voting reports so that they may evaluate this information in the context of the proxy advisors' voting recommendations.

[2] https://www.sustainalytics.com/press-release/sustainalytics-glass-lewis-corporate-governance-data-services-offering/

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Transparency of Firm Procedures

Currently, proxy advisory firms are largely unregulated, resulting in a lack of transparency. There is no regulatory regime that governs the manner in which these firms develop their policies or form the recommendations or ratings they make. While ISS can be commended for incorporating a public survey of interested parties as part of its annual policy development, there remain issues with this process. For example, while the survey is indeed open to institutional investors, corporate executives, board members and any other interested parties, it is unclear how ISS determines the particular topics, survey questions and response options it publishes for comment each year. Further, ISS does not disclose how it weighs the survey responses in its final policy changes. Notwithstanding their time and effort in participation, corporates generally see little evidence that their points of view have been taken into account in ISS' development of its final policies. Thus, it is unclear how ISS actually internalizes the survey responses it does receive, including whether one group of respondents drives the ultimate policy changes or not.

Glass Lewis does not conduct a formalized survey solicitation process, although it does allow stakeholders to provide feedback on its proxy voting guidelines via its website on an *ad hoc* basis and relies on an "independent research advisory council," which includes limited corporate representation, for feedback on its voting policies. As with ISS, it is unclear how any of the foregoing feedback is ultimately reflected in Glass Lewis' decisions to make policy changes or in the substance of any changes made.

Balanced regulation by the SEC, as contemplated by the CGFA, could improve proxy advisor transparency.

Due Process

Proxy advisory firms make proxy recommendations on every public company in the United States, and thousands of public companies around the world. The scale and complexity of making proxy voting recommendations for thousands of companies during "proxy season" effectively requires proxy advisors to do all their analysis from February to June, with most recommendations coming out during a 6-8-week period.

Reading and accurately digesting thousands of proxy statements, annual reports, and – increasingly – corporate social responsibility and sustainability statements in a condensed time period creates an environment conducive to errors. Given the volume of analysis and the likelihood that errors or misjudgments may occur, it would be reasonable to assume that companies would have the opportunity – indeed, the right – to review and correct any inaccuracies in the proxy voting reports. To the contrary, there is currently no requirement for proxy advisors to provide companies with an opportunity to review and correct voting reports prior to their issuance.

As a result, most companies today are not able to see proxy voting reports about themselves until after each report has been issued. ISS provides its draft proxy voting reports to S&P 500 companies, but provides draft reports to smaller companies only on a discretionary basis or only after the companies have completed a paid subscription to their service. Further,

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any draft report that is provided to a company is accompanied by a very short turnaround time of no more than 72 hours before final publication to ISS' institutional investor clients. Additionally, ISS does not normally provide draft reports for any special meeting or any meeting where the agenda includes a merger or acquisition proposal, proxy fight or "any item that ISS, in its sole discretion, considers to be of a contentious or controversial nature."[3] Thus, in the situations where an ISS report may be the most consequential, companies often are not able to view a draft at all. Glass Lewis does not provide a copy of its final reports to any public company that does not pay for its reports or otherwise subscribe to its services.

The inability to review draft reports from proxy advisory firms as a matter of right means that companies who want factual errors or omissions corrected are often unable to get a response from proxy advisory firms until it is too late, i.e., until after votes have been cast on the basis of a recommendation that relied – at least in part – on inaccurate or incomplete information.

The balanced regulation contemplated by the CGFA would be a real step towards the due process required by traditional notions of fairness.

Conclusion

We commend this Committee for taking a detailed look at the regulation of proxy advisory firms and urge your support of the concepts embodied in the strongly bipartisan and balanced Corporate Governance Fairness Act of 2018. This legislation would help ensure that investors receive the transparency and regulatory protections they deserve, that public companies continue to thrive and create jobs, and that our capital markets remain the driver of economic growth in America.

Sincerely,

Darla C. Stuckey

Darla S. Stuckey
President & CEO
Society for Corporate Governance

cc: The Honorable Senator Jack Reed
The Honorable Senator David Perdue
The Honorable Senator Doug Jones
The Honorable Senator Thom Tillis
The Honorable Senator John Kennedy

[3] https://www.issgovernance.com/contact/faqs-engagement-on-proxy-research/

REVISED AND EXTENDED REMARKS AT THE GREENWICH ROUNDTABLE PANEL DISCUSSION ON ESG: PATH TO PROSPERITY OR PHILANTHROPIC CONFUSION BY BARBARA NOVICK, VICE CHAIRMAN, BLACKROCK

BLACKROCK®

Revised and Extended Remarks at the Greenwich Roundtable
Panel Discussion on ESG: Path to Prosperity or Philanthropic Confusion
Barbara Novick, Vice Chairman

Greenwich, CT
January 17, 2019

Good morning, and thank you for inviting me to the Greenwich Roundtable. I plan to cover several aspects of Environmental, Social, and Governance (ESG) investing, starting with some historical context then touching on the regulatory landscape. Mostly, we will talk about the 'value' vs. 'values' distinction and the data behind value-driven investing. And finally, I will touch on investment stewardship and the role of asset owners.

Historical Context

ESG & Sustainable Investing reflects a decades-long journey. As I will discuss today, what began as a '*values*' discussion has evolved over time and is increasingly about '*value*', and the idea that governance, environmental and social issues can drive investment value over time.

In April, 2006, the Principles of Responsible Investing (PRI) were launched with 63 signatories accounting for $6.5 trillion of assets under management.[1] The PRI's goal was "to commit to… incorporate ESG into investment analysis and decision making processes" and to "report on…activities and progress towards implementing the Principles.[2] Over the past 12 years, the PRI have grown to over 1900 signatories accounting for over $80 trillion in AUM.[3] In the past five years alone, the number of signatories has increased by 65% and AUM has increased by 240%.

ESG factors are gaining prominence in the asset management industry and are now incorporated into a sizable portion of the world's managed asset. According to the Global Sustainable Investment Alliance (GSIA), approximately 26% of the assets under management globally already incorporate ESG factors in some form.[4] Not surprisingly, companies and asset owners are aligning their businesses and their investments with the UN Sustainable Development Goals (SDGs).[5] According to KMPG's survey of Corporate Responsibility Reporting, 40% of the world's 250 largest corporations discuss the SDGs in their corporate reporting.[6]

While we can all agree that interest in sustainable investing has soared within the business community, there is little agreement about what is actually being discussed. The problem starts with a range of definitions of terms. For example: 'ESG Investing', 'Sustainable Investing',

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1 "About the PRI", PRI, available at https://www.unpri.org/pri/about-the-pri.

2 "What are the Principles for Responsible Investment?", PRI, available at https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment.

3 See Footnote 1.

4 "2016 Global Sustainable Investment Review", Global Sustainable Investment Alliance, pg. 7, available at http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf.

5 More information about the UN Sustainable Development Goals available at https://www.un.org/sustainabledevelopment/sustainable-development-goals/.

6 "How to report on the SDGs: What good looks like and why it matters" (Feb. 2018), KPMG, pg. 6, available at https://assets.kpmg/content/dam/kpmg/xx/pdf/2018/02/how-to-report-on-sdgs.pdf.

'Responsible Investing', 'Ethical Investing', and 'Impact Investing' are often used interchangeably, requiring one to consider the speaker and the context of their remarks to understand the meaning of the terms.

Current Debate

The increased interest in sustainable investing has led to a public debate about whether corporations should pursue 'Profit or Purpose', a debate which is sometimes framed as 'Milton Friedman versus Larry Fink'.

In 1962, in *Capitalism and Freedom*, Friedman wrote:

> *There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits…*[7]

Last year, in what has become known as 'Larry's letter' (referring to the annual letter Larry Fink, CEO of BlackRock, writes to other CEOs around the world) Larry Fink wrote:

> *Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.*[8]

When this letter was written, we did not realize how much of an uproar it would create. However, thinking about the world we live in today, it would seem obvious that companies face different pressures than they did in 1962. As we have seen, the 'age of the internet' and the mindset of Millennials has changed the environment for businesses.

If you are not convinced of this, just think about how the '#MeToo movement' has changed views on sexual harassment. Or think about the 20,000 employees who walked out in protest at Google in November 2018. Finally, think about the employment numbers in the US and the current 'war for talent'. Should companies treat their employees well to retain talent, or should they act as if everyone is a cog in a wheel that can be quickly and easily replaced?

The discussion around sustainable investing has not been immune from this debate about profits versus purpose as voices argue whether consideration of ESG factors is a push for certain values or rather another factor that is a driver of shareholder value. Yet, it seems obvious that human capital management is an important aspect of managing companies. And this is just one example of sustainability.

Hopefully your takeaway from today's talk will be that we do not have a binary choice, and that due to broad and accelerating societal trends 'Profit AND Purpose' are increasingly symbiotic and aligned, particularly in regards to ESG.[9]

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[7] Milton Friedman, *Capitalism and Freedom* (1962).

[8] Larry Fink's 2018 Letter to CEOs: A Sense of Purpose, available at https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter.

[9] For more on the alignment of profit and purpose see Larry Fink's 2019 Letter to CEOs: Purpose and Profit, available at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

Regulatory Landscape

Regulation plays an important role in this discussion. To start, there are obvious regional differences in how to think about and how to approach ESG issues. For example, the EU is actively debating how far to go, contemplating everything from mandatory reporting, to requiring the inclusion of ESG criteria in investing, to defining a taxonomy around what it means to be 'green', and more. Meanwhile, the US has taken a less proactive approach, especially when it comes to prescriptive rules.

SEC Chairman Clayton raised issues related to disclosure and reporting at a recent Investor Advisory Committee meeting. In his own words:

> *…a key responsibility of the SEC is to ensure that the mix of information companies provide to investors facilitates well-informed decision making. The concepts of materiality, comparability, flexibility, efficiency and responsibility are the linchpins of our approach.*

Chairman Clayton goes on to say:

> *…companies should focus on providing material disclosure that a reasonable investor needs to make informed investment and voting decisions based on each company's particular facts and circumstances…*[10]

Similarly, IOSCO just issued a statement on ESG disclosures which stated issuers should provide "full, accurate, and timely disclosure of financial results, risks, and other information which is material to investors' decisions."[11]

And, of course, the Department of Labor (DoL) weighed in this past year, particularly related to how collateral benefits relate to an investment advisors' fiduciary duty to its clients. In its Field Assistance Bulletin in April 2018, the DoL states:

> *…the Department reiterated its longstanding view that, because every investment necessarily causes a plan to forego other investment opportunities, plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals"*

While this put many ESG proponents into a tailspin, the full guidance goes on to say:

> *To the extent ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors.*[12]

Which takes us to the heart of the debate.

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[10] Chairman Jay Clayton, "Remarks to the SEC Investor Advisory Committee", (Dec. 13, 2018), full remarks available at https://www.sec.gov/news/speech/clayton-remarks-investor-advisory-committee-meeting-121318.

[10] See "MSCI ESG Focus Indexes" at https://www.msci.com/msci-esg-focus-indexes.

[11] IOSCO, "Statement on Disclosure of ESG Matters by Issuers", (Jan. 18 2019), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD619.pdf.

[12] United States Department of Labor, Employee Benefits Security Administration, Field Assistance Bulletin No. 2018-01, (Apr. 23, 2018), available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.

Investment Thesis: Value vs. Values

Are we talking about 'value' or 'values'? Or as my fellow panelist this morning, Rob Sitkoff, calls them 'Risk Return ESG' or 'Collateral Benefits ESG'?[13]

'Values-based investing' is a client-driven concept where the asset owner has a moral or ethical view such that a certain industry does not align with their values. These clients choose to specifically exclude (or include) investments based on the businesses companies are involved in. This approach has the potential to change what is included in the investible universe and hence incurs tracking error to traditional market benchmarks, both realities which investors understand and accept. A large swath of ESG style investment products and strategies continue to employ this approach.

'Value-based investing' is a quite different concept. Here, the investor accepts that insights into material governance, environmental, and social factors can be both positive and negative drivers of returns. This is an investment thesis, and not a moral or ethical perspective on companies. For example, a portfolio manager might choose to underweight tobacco companies due to concerns about regulation or reduced demand for cigarettes rather than a wholesale exclusion based on values.

As I mentioned earlier, the lack of agreement on definitions is part of the challenge in discussing and debating the topic of ESG investing, and the values versus value distinction is a prime example of that definitional challenge.

Yafit Cohn, Associate Group General Counsel at The Travelers Companies, expressed the definitional problem well at the same hearing where Chairman Clayton made the remarks I quoted earlier. She noted that "*ESG has been conflated with impact investing….and with corporate social responsibility*". Having spent a year grappling to understand ESG data and ESG ratings, Yafit concluded:

> *…ESG, at its core, refers to the risks and opportunities that could impact a company's ability to create value over the long term – and how the company is managing those risks and taking advantage of those opportunities to ensure its long-term economic sustainability*[14]

We agree with this assessment. While ESG investing began years ago with values-based strategies, and some asset owners continue to pursue values-based strategies, a growing number of institutional investors are embracing ESG as they take a more investment-oriented or *value-based* approach. At BlackRock, we call this '*Sustainable Investing*'.

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[13] See Max M. Schanzenbach and Robert. H. Sitkoff, "The Law and Economics of Environmental, Social, and Governance Investing by a Fiduciary", *Northwestern Law & Econ Research Paper No. 18-22*, (Jan. 2019).

[14] United States Securities and Exchange Commission Investor Advisory Committee Meeting, Dec. 13, 2018. See full video recording of the meeting at https://www.sec.gov/video/webcast-archive-player.shtml?document_id=iac121318.

Understanding ESG Data

In order to use ESG factors to drive long-term value for our clients, it is important to have consistent, high quality ESG data. A key question then is what data should investors consider? And, of course, is this data available?

If you go back ten years, the answer would be unequivocally: 'No'. In fact, limited data was available, and the data that was available was of poor quality. However, a decade is a long time, and the data has clearly evolved and improved since then. Yafit pointed out in that same testimony that the ecosystem of for-profit and non-for-profit ESG-related entities is exploding. She tallied a total of 55 surveys and data verification requests that Travelers received from ESG rating organizations in just one year.[15]

At BlackRock, we recently created a spreadsheet to track 75 known providers of ESG data. These organizations include: MSCI, Sustainalytics, ISS, Morningstar, JUST Capital, Ceres, and the Carbon Disclosure Project (CDP). With this breadth of data providers, it is no wonder that companies are complaining about 'survey fatigue'.

While consistent, high quality data is important, the proliferation of data providers and rating agencies creates an expensive and wasteful situation where companies devote increasing resources for reporting and fact checking. Meanwhile, there is little agreement on which information is useful.

Unfortunately, the increased amount of work being done by corporates to answer this bewildering array of survey and data requests does not yet translate into consistently helpful information for investors. In fact, differing scoring systems produced by ESG rating agencies can create confusion as the scores can vary significantly for an individual company and an aggregate portfolio depending on whose standards are used. For example, Yafit cited the differing ratings for an unnamed peer of Travelers in the insurance sector: Sustainalytics scored them at 28.7%, while RobecoSAM scored them at 58% and CDP awarded them an A-.[16] Clearly the proliferation of data providers, absent clearer standards and more consistent reporting, serves neither corporates nor investors particularly well.

Chairman Clayton noted that: "Each company, and each sector, has its own circumstances, which may or may not fit within a standard framework."[17] This is an important insight, and it highlights the challenge for companies and investors alike.

Two of the frameworks we find most useful are:

- **TFCD**, which has created a flexible framework for disclosure. While it is intended for climate-related disclosure, the framework can be applied to other environmental and social factors as well.

- And **SASB** which has taken an industry-specific approach with a focus on material financial issues.

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[15] Ibid.

[16] See Footnote 14.

[17] See Footnote 10.

Given the importance of these factors, the time has come for standard setters to come together. Otherwise, investors need to lead the way by coalescing around a set of standards. While we understand concerns that the data is far from perfect, we also believe significant investment insights can be gained from the data that is available today.

At BlackRock, we break ESG data into three main categories:

1. **Company disclosure**. As I noted earlier, an increasing number of companies are disclosing more ESG data either for regulatory reasons or in response to social pressure. While this information is still incomplete and often lacks standardization, there is definitely more data to consider, which was not the case a decade ago.

2. **ESG data providers**. The various providers start with company disclosures and then do additional research, find other sources, interpret the data, and add a subjective lens. While the ratings vary, understanding their methodology and looking beyond the headlines to understanding the components provides useful insights. For example, MSCI and Sustainalytics each have hundreds of research analysts who aggregate thousands of ESG data points which are weighted into 'G', 'E', and 'S' pillars, and then rolled into a single ESG headline score.[18]

3. **Big data approaches**. New techniques are available to source and analyze large data sets. Whether it is data we inadvertently leave on-line, or it is deliberately written evaluations, this is yet another source of ESG information. For example, in a world where human capital management reflects the importance of employees as stakeholders, mining GlassDoor for employee sentiment data provides useful insight into a company's human capital management practices.

Investors need to recognize that relevant ESG data changes over time. For example, the focus on cyber risks and data privacy – which are often considered under the Social pillar – are relatively recent. To put this in perspective, MSCI downgraded Equifax to CCC in 2016 based on weakness in this area. This downgrade preceded the Equifax data breach.[19]

Integrating ESG Factors

At BlackRock, we believe governance, environmental and social factors are important to the long-term financial performance of companies. Once again, we find ourselves in synch with Yafit as we think of these factors as both risks and opportunities. We are committed to identifying data that is material to companies, and incorporating this data into our decision process. We define 'ESG Integration' as the practice of incorporating *financially material* ESG information into investment decisions to enhance risk-adjusted returns. Importantly, ESG integration is not a values-based exercise.

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[18] More information on MSCI ESG scoring available at https://www.msci.com/esg-ratings; and more information on Sustainalytics ESG scoring available at https://www.sustainalytics.com/esg-ratings/.

[19] See "MSCI ESG Ratings May Help Identify Warning Signs", MSCI, available at https://www.msci.com/documents/1296102/6174917/MSCI-ESG-Ratings-Equifax.pdf/b95045f2-5470-bd51-8844-717dab9808b9.

Over the past few years, BlackRock has begun integrating ESG factors into our investment platform. Today we offer sustainable investment products across asset classes, including equity, fixed income, cash, and real estate and insurance.[20] Following are a few examples of ESG integration at BlackRock:

1. BlackRock's Fundamental Active Equity (FAE) team, created an ESG Risk Window which identifies what this team believes to be the most relevant sector-specific ESG risk metrics for a given issuer with the goal of highlighting and better understanding if and how a company is managing those risks.
2. BlackRock's Emerging Markets Debt (EMD) team uses an emerging markets corporate ESG Scorecard which they feed into their standard corporate credit analysis. The analysts on this team believe that the management and progress in specific ESG metrics can signal credit quality of emerging markets issuers and that this is underappreciated by the market today.

3. BlackRock's Cash team has constructed its own proprietary 'responsible cash' metric built off a set of the most material key performance indicators (KPIs) for their asset class. This team now includes this factor in its investment committee decision-making process for corporate issuers.[21]

4. BlackRock's Real Assets team uses a proprietary ESG investment questionnaire to highlight ESG risks for further discussion with the relevant investment committees. Given the nature of investing in long-term, physical assets, this team believes that poor performance in specific ESG areas represents a material risk to the investment thesis. The Real Assets team incorporates relevant ESG requirements into the contracts of third party vendors and managers to help ensure they minimize these risks by operating in line with relevant ESG requirements and good industry practices.

Investment Stewardship

Larry's letter also highlighted the importance of investment stewardship, especially in index portfolios which provide long-term capital to thousands of companies. As with ESG Integration, investment stewardship is not about making 'social decisions' with our clients' money, nor is it about imposing 'values' on companies. Rather, investment stewardship is about maximizing long-term value. Our engagement emphasizes issues that we believe have a material impact on a specific company.

In our stewardship activities, we prefer to engage first to build a dialogue with a company rather than surprise them with a negative vote. We also believe engagement leads to more informed voting than simply following the recommendations of a proxy advisor.

Of course, it's easy to measure voting and compare across managers – which many people do. We caution, however, that voting is only one aspect of investment stewardship. As part of our commitment to being transparent, we publish on our website: engagement priorities, voting guidelines, bulletins and commentaries on selective issues, quarterly regional reports, global annual report, and actual voting data. And this morning we just rolled out an upgraded site with

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[20] See more about BlackRock Sustainable investing at https://www.blackrock.com/ch/individual/en/themes/sustainable-investing.

[21] On January 22, 2019, BlackRock announced its intention to launch an environmentally-aware money market fund called the BlackRock Liquid Environmentally Aware Fund ("LEAF"). See more in our press release at https://www.businesswire.com/news/home/20190122005937/en/.

improved navigability.[22] I encourage you to look at our website to get a better understanding of the issues we are focused on and actual engagement outcomes.

Our approach is very much aligned with Chairman Clayton's stated view that:

> *….asset managers who are required to vote in the best interest of their clients – should also focus on each company's particular facts and circumstances…Advisers cannot put their own interests ahead of the interests of their clients…*[23]

…even on ESG matters.

Client Perspectives on Sustainable Investing

A discussion of sustainable investing would not be complete without touching on the asset owner role in investing. Asset managers act as fiduciaries, investing on behalf of asset owners, whom I will refer to here as the 'clients'.

Client motivations in the ESG space fall into one of two categories: 'avoid' or 'advance'. As mentioned earlier, you can think of 'avoid' as exclusionary screens (e.g. tobacco, fossil fuels, defense) that reflect the social values of the client.

'Advance', on the other hand, is both broader and more nuanced, and we identify three sub-categories:

1. **ESG –** These are portfolios optimized around ESG ratings to produce a broadly exposed portfolio with better than average ESG scores. For example, we worked with MSCI to develop the MSCI Focus Series which has produced a tighter tracking error to the mother index compared to the MSCI Leader Series.[24]

2. **THEMATIC –** These are portfolios designed to emphasize a specific positive environmental or social goal. For example, investing in companies or projects focused on wind and solar energy.

3. **IMPACT –** These are portfolios targeting a specific sustainable outcome alongside financial return. For example, 'green bonds' have emerged as a new asset class which allows investors to direct monies toward environmentally friendly projects while still having traditional fixed income financial exposure.

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[22] See BlackRock Investment Stewardship's website at https://www.blackrock.com/corporate/about-us/investment-stewardship.

[23] Chairman Jay Clayton, "Remarks to the SEC Investor Advisory Committee", (Dec. 13, 2018), full remarks available at https://www.sec.gov/news/speech/clayton-remarks-investor-advisory-committee-meeting-121318.

[24] See "MSCI ESG Focus Indexes" at https://www.msci.com/msci-esg-focus-indexes.

Conclusion

The landscape for ESG investing is a dynamic one. In the last decade or so there has been dramatic progress made in advancing the field from a 'values-based' exercise to a 'value-driven' approach that holds promise for combining the ability to 'do well' while also 'doing good'. While there is room for further development and improvement in the realm of ESG data, these challenges have not stopped asset managers and investors alike from pursuing sustainable investing options with real results.[25] ESG is one area in asset management that has great potential to shape the industry as we know it today as well as to be a manifest link between purpose and profits in corporate America.

[25] See more on BlackRock's approach to sustainable investing in "Sustainability: The future of investing" (Jan. 2019), available at https://www.blackrock.com/corporate/literature/whitepaper/bii-sustainability-future-investing-jan-2019.pdf; "Sustainable investing: a 'why not' moment – Environmental, social and governance investing insights" (May 2018), available at https://www.blackrock.com/corporate/literature/whitepaper/bii-sustainable-investing-may-2018-international.pdf; and "What is sustainable investing?", available at https://www.ishares.com/us/strategies/sustainable-investing.

Important Notes

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"BLACKROCK ANALYSIS HELPS DEFINE CLIMATE-CHANGE RISK",
FINANCIAL TIMES SUBMITTED BY SENATOR SHERROD BROWN

FTfm Fund management

BlackRock analysis helps define climate-change risk

Homes in Paradise, California, were destroyed by a wildfire in February. BlackRock warns that the effect of climate change will only accelerate (Justin Sullivan/Getty Images)

Siobhan Riding 11 HOURS AGO

Investors underestimate the risks that extreme weather poses to their portfolios, according to landmark research by BlackRock that could drastically alter how the investment industry considers climate change in its risk management processes.

BlackRock's study looked at three US asset classes — municipal bonds, commercial real estate and US utility stocks — and said

climate change was already having a tangible effect on securities. It warned that the trend would only accelerate.

The study, published Thursday, said investors in the $3.8tn municipal bond market could experience losses as vulnerable cities saw their economies suffer, with gross domestic product dipping by more than 1 per cent.

BlackRock also expected securities backed by commercial real estate mortgages to face an average loss rate of up to 3.8 per cent as properties faced cash flow shortages after severe storms and floods.

The greater incidence of hurricanes and wildfires over the past 12 months has highlighted the effect of global warming. Investors, however, have been slow to take note of how climate risks could affect their portfolios.

Asset owners and asset managers have instead focused on how the shift to a lower-carbon economy will affect investments.

"Investors who are not thinking about climate-related risks, or who view them as issues far off in the future, may need to recalibrate their expectations," BlackRock said.

The world's largest asset manager noted that some investors regarded change such as rising sea levels as being outside their

traditional outlook. As a result they had discounted risks "already lurking" in their portfolios.

Mapping the damage

Estimated climate-related impact on U.S. regional GDP, 2060-2080

The map shows the projected GDP impact in 2060-2080 on U.S. metropolitan areas under a "no climate action" scenario. Climate changes are measured relative to a 1980 baseline. The analysis includes the effect of changes in crime and mortality rates, labor productivity, heating and cooling demand, agricultural productivity for bulk commodity crops, and expected annual losses from coastal storms. It accounts for correlations across these variables and through time — and excludes a number of difficult to measure variables such as migration and inland flooding.

Brian Deese, head of sustainable investing at BlackRock and a former adviser on climate and energy policy to US president Barack Obama, said the lack of robust data had meant the extent of the underpricing of these risks had not been clear until now.

"Physical climate risks have been perennially hard to measure," said Mr Deese. Part of the fault for this lies in outdated climate-science models, which do not take into account the "recent acceleration in the frequency and severity of extreme weather events".

Another complication in measuring climate risk is the need for detail relating to the location of assets. For example, to measure a utility company's exposure, investors have to know the location of its plants, property and equipment.

"Investor reaction ahead of forecasted hurricanes is muted because the exact location of landfall — and the power plants that will be affected — are not known with certainty," said BlackRock.

Mr Deese described the analysis as a "breakthrough" due to the way it combined detailed asset-level information with updated climate models and big data.

BlackRock, which had research group Rhodium as its partner in the study, said it planned to build the data into investment and risk management processes used by its portfolio managers.

"The research demonstrates that if you are looking at these asset classes and you are not asking questions about how climate-related risks are affecting your investments, you are missing risks that are in the market today," said Mr Deese.

Joanne Etherton from environmental law firm ClientEarth, said that BlackRock's acknowledgment of the scale of climate-related financial risks was "a thunderbolt for investors".

"The world's largest asset manager has now accepted that markets are consistently underpricing physical climate risks — that means all investors should be taking a careful look at the models they are currently using and recalibrating their expected returns."

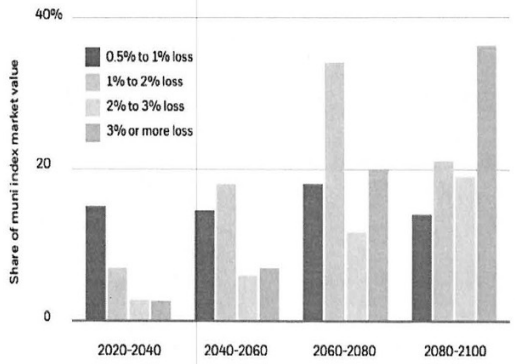
BlackRock found that all major US metropolitan areas were already suffering mild to moderate losses in GDP as a result of cumulative change to the climate since 1980. Miami topped the list with estimated losses of more than 1 per cent. The city's economic losses were predicted to rise to 4.5 per cent of GDP by the end of the century, mainly driven by hurricanes and rising seas.

BlackRock estimated that 58 per cent of metropolitan areas faced climate-related GDP hits of 1 per cent or more by 2060-80 unless decisive action was taken.

This situation has implications for municipal bonds underwritten by these cities. BlackRock said communities vulnerable to economic loss would account for 15 per cent of the market value of the S&P National Municipal Bond Index within the next decade.

It said that to avoid incurring losses on municipal bonds, investors needed to assess issuers' resolve and financial ability to fund projects to mitigate climate risk.

Muni market share at risk of climate-related GDP losses, 2020-2100



The chart shows the estimated market value share of the muni market exposed to GDP losses of various magnitude through 2100 under a "no climate action" scenario. For example, roughly 20% of the market value of the current muni index is expected to come from regions suffering annualized average losses of up to 3% or more of GDP from climate change by 2060–2080. We use the upper bound of the 66%, or "likely," range of losses to illustrate a plausible risk scenario.

Climate change is already taking a toll on US utility stocks. Hurricanes come top of BlackRock's relative impact ranking due to the threat they pose to power and water supply.

The company applied climate scores to utility groups alongside their 10-year average price-to-earnings ratio. It found that the most climate-resilient utilities were already trading at a premium. It expected this premium to increase as the risk became clearer.

Such a scenario suggests that investors that give more weight to companies with low climate-risk exposure and less weight to those with high exposure will do well over time.

BlackRock also sounded the alarm on the effect that climate risk would have on commercial property underlying mortgage-backed securities.

The company combined climate science models with data for 60,000 such properties in the US and found that the median risk of a property tied to such loans being hit by the most severe level of hurricane had risen by 137 per cent since 1980. Both category 4 and 5 hurricanes on the Saffir-Simpson scale will cause "catastrophic damage".

Moreover, the risk of a property being hit by a category 5 hurricane was expected to rise 275 per cent if no climate action was taken.

A separate analysis of hurricanes affecting Houston and Miami found that about 80 per cent of commercial properties tied to these loans fell outside flood zones, meaning their insurance cover could be inadequate.

All this could affect property cash flows and commercial loan defaults. BlackRock said the average expected loss rate on commercial mortgage-backed securities would rise to 3.8 per cent.

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STATEMENT SUBMITTED BY JANA MORGAN, DIRECTOR OF CAMPAIGNS AND ADVOCACY, INTERNATIONAL CORPORATE ACCOUNTABILITY ROUNDTABLE

"The Application of Environmental, Social, and Governance Principles in Investing and the Role of Asset Managers, Proxy Advisors, and Other Intermediaries"

Senate Committee on Banking, Housing, and Urban Affairs
April 2, 2019, 10:00 AM

Testimony of Jana Morgan, Director of Campaigns and Advocacy, International Corporate Accountability Roundtable (ICAR)

Chairman Crapo, Ranking Member Brown, and esteemed members of the Senate Committee on Banking, Housing, and Urban Affairs:

My name is Jana Morgan, and I am the Director of Campaigns and Advocacy at the International Corporate Accountability Roundtable (ICAR). ICAR is a coalition of forty-five environmental, human rights, and corporate responsibility non-profit organizations. We harness the collective power of progressive organizations to push governments to create and enforce rules over corporations that promote human rights and reduce inequality.

ICAR has long advocated for the SEC to promulgate mandatory Environmental, Social, and Governance (ESG) disclosures by public companies, as this information is material to reasonable investors. In our 2013 report, *Knowing and Showing: Using U.S. Securities Laws to Compel Human Rights Disclosure,* we demonstrated how disclosure of human rights policies, practices, and impacts was material given the increased public interest, international accords and efforts to address this information gap, and voluntary recognition of the current and potential effects of this information on companies' performance and operations.[1] In the last six years, the substantial increase in the number of companies voluntarily reporting on ESG factors, investors calling for increased ESG disclosure, and States and stock exchanges requiring mandatory disclosure of ESG information further bolsters our argument that now is the time for the SEC to regulate.

Ernst & Young reports that ESG factors are no longer a niche consideration, with "investor interest in non-financial information span[ning] across all sectors," and 61.5% of investors considering non-financial information relevant to their investments overall.[2] Worldwide, investors managing $68.4 trillion in capital are committed to incorporating ESG factors into

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[1] International Corporate Accountability Roundtable (ICAR), Knowing and Showing: Using U.S. Securities Laws to Compel Human Rights Disclosure (2013), https://static1.squarespace.com/static/583f3fca725e25fcd45aa446/t/58657a0ef5e2317207953 2f9/1483045394268/ICAR-Knowing-and-Showing-Report5.pdf.

[2] Ernst & Young & Boston College Center for Corporate Citizenship, Vale of Sustainability Reporting 18 (2013), https://www.ey.com/Publication/vwLUAssets/EY_-_Value_of_sustainability_reporting/$FILE/EY-Value-of-Sustainability-Reporting.pdf.

decision-making through the UN Principles for Responsible Investment and 75% of the Global 250 utilizes the Global Reporting Initiative (GRI) standards to report on sustainability issues."[3] Additionally, a majority of the largest companies are currently making voluntary sustainability disclosures, with 85% of S&P 500 companies producing such reports in 2017.[4]

At least 23 countries have independently enacted legislation within the last 15 years requiring public companies to report on ESG issues.[5] In 2014, the European Union (EU) issued the Non-Financial Reporting Directive which requires wide-scale, mandatory ESG reporting.[6] As of May 2014, all 28 member States have transposed these reporting requirements into national law.[7] In addition to these reporting requirements, seven stock exchanges require social and/or environmental disclosure as part of their listing requirements, including Australia's ASX, Brazil's Bovespa, India's Securities and Exchange Board, the Bursa Malaysia, Oslo's Børs, the Johannesburg Stock Exchange, and the London Stock Exchange.[8] At least nine countries currently require pension funds to disclose the extent to which they incorporate ESG information into their investment decisions.[9] These movements towards mandatory reporting highlight the broad-scale belief that ESG information is material and must be disclosed in order to inform investor decision-making.

In the United States, over the past year approximately 400 shareholder resolutions were filed requesting increased disclosure on ESG issues—another sign of expanding interest in these issues.[10] Today, large index funds hold the majority share in over 40% of publicly owned companies. As such, index funds are necessarily being required to weigh in on these propositions in the form of their majority proxy vote. Some critics have stated that index funds and proxy advisers that vote in favor of increased ESG issues may breach their fiduciary duties

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[3] *See,* U.N. Principles for Responsible Investment, PRI-11 year growth of AO (all signatories (Asset Owners [sic], Investment Managers and seride [sic] providers) and respective AUM, Excel sheet available for download at *About the PRI*, U.N. Principles for Responsible Investment, http://www.unpri.org/about.

[4] Governance and Accountability Institute Inc., "85% of the S&P 500 Index Companies Publish Sustainability Reports in 2017" (Mar. 20, 2018), https://www.ga-institute.com/press-releases/article/flash-report-82-of-the-sp-500-companies-published-corporate-sustainability-reports-in-2016.html.

[5] *See,* Initiative for Responsible Investment, Corporate Social Responsibility Disclosure Efforts by National Governments and Stock Exchanges (Mar. 12, 2015), http://iri.hks.harvard.edu/files/iri/files/corporate_social_responsibility_disclosure_3-27-15.pdf.

[6] *See,* Directive 2014/95/EU, of the European Parliament and of The Council of 12 Oct. 2014 as regards disclosure of non-financial and diversity information by certain large undertakings and groups, 2014 O.J. (L 330) 1, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0095&from=EN.

[7] European Commission, "Non-Financial Reporting Directive-Transposition Status (May 24, 2018), https://ec.europa.eu/info/publications/non-financial-reporting-directive-transposition-status_en.

[8] *See* Initiative for Responsible Investment, *supra* note 5.

[9] *See,* Id. These countries include the UK, Sweden, Australia, Belgium, Canada, France, Germany, Italy, and Japan.

[10] As You Sow, "Proxy Preview 2019 Reveals Intensified Shareholder Pressure on Corporations Across a Wide Range of ESG Issues," (Mar. 12, 2019), https://www.asyousow.org/press-releases/proxy-preview-2019-shareholder-resolutions.

to shareholders—as voting for ESG disclosures might be a tactical decision in order to build a fund's reputation with the public and not a decision based on maximizing the profit of fund members. This analysis is wrong, as it presumes that ESG issues are not material.

Information about a company's ESG policies, practices, and impacts is material to a reasonable investor. This information is material both from a strictly financial viewpoint, and a broadened conceptualization of environmental or socially material information. A multitude of studies have concluded that a company's performance on ESG issues is directly linked to better corporate performance in the long-term. A 2014 review of numerous empirical studies analyzing ESG data and corporate financial performance found overwhelming links between sustainability and profit: 90% of the analyzed studies showed that sound sustainability standards lowered firms' cost of capital; 80% of the studies showed that companies' stock price performance is positively influenced by good sustainability practices; and 88% of the studies showed that better ESG practices result in better operational performance.[11] Since then, additional studies have confirmed these findings, including:

- A June 2017 Bank of America Merrill Lynch study which found ESG factors to be "strong indicators of future volatility, earnings risk, price declines, and bankruptcies."[12]
- A June 2017 research report by Allianz Global Investors, which concluded that heightened transparency of ESG disclosure lowered companies' cost of capital by reducing the "investment risk premium" that sophisticated investors would require.[13]
- A September 2017 Nordea Equity Research report, which found that there is "solid evidence that ESG matters, both for operational and share price performance."[14]

Individual investors, index funds, or proxy advisors taking a long-term approach to wealth maximization, instead of seeking short-turn returns on investments, necessarily find ESG information financially material.

Under the growing global concept of "double materiality," ESG information can be considered both financially material to investors and socially or environmentally material to investors, consumers, employees, communities, and civil society organizations.[15] Environmental or social

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[11] Gordon L. Clark, Andreas Feiner & Michael Viehs, From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance (2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281.
[12] Bank of America Merrill Lynch, Equity Strategy Focus Point—ESG Part II: A Deeper Dive (June 15, 2017), https://www.iccr.org/sites/default/files/page_attachments/esg_part_2_deeper_dive_bof_of_a_june_2017.pdf.
[13] Allianz Global Investors, "Added value or a mere marketing tool? What does ESG mean for investments?" (June 1, 2017), https://uk.allianzgi.com/en-gb/b2c/insights/esg-matters/2017-06-01-added-value-or-a-mere-marketing-tool.
[14] Nordea Equity Research, "Strategy & Quant: Cracking the ESG Code" (Sept. 5, 2017), https://nordeamarkets.com/wp-content/uploads/2017/09/Strategy-and-quant_executive-summary_050917.pdf.
[15] European Commission, Consultation Document on the Update of the Non-Binding Guidelines on Non-Financial Reporting,

materiality refers to the impact of a company's activities outside of itself. These two risk perspectives are increasingly likely to overlap, with environmental or social impacts leading to financial implications, which then render them financially material. Take, for example, information relating to human rights policies, practices, and impacts. Poor human rights policies and practices that lead to negative human rights impacts can directly affect the financial stability of a corporation. Non-compliance with national and international human rights law can lead to financial penalties levied by the State, liability for human rights abuse, and litigation associated with damages from corporate activities.[16] To illustrate, in 1984 a toxic fume release at a Union Carbide factory in Bhopal, India killed between 7,000 and 10,000 people, marking it as one of "the world's worst industrial disasters."[17] Union Carbide employees were later found criminally negligent by the Indian Supreme Court and ordered to pay millions in damages to both the victims and for environmental cleanup.[18]

Additionally, inadequate human rights policies and practices can cause financial instability in a number of other ways. For example, they can cause indirect impacts on a company's reputation affecting relationships with consumers, clients, employees, recruits, investors, and shareholders, all of whom might prefer to disassociate from operations that are complicit with adverse human rights outcomes. One such example occurred in the 1990s when Nike was accused of using child labor in its Chinese factories, paying workers less than minimum wage in Indonesia, and egregious violations of labor rights in Vietnam.[19] Since then, Nike has been further implicated in labor violations, especially in Bangladesh and other Asian countries, directly leading to significant financial repercussions due to continued public protest of Nike's practices and related drop in sales.[20] Similarly, the potential deterioration of relationships between corporations, governments, and local communities caused by a company's adverse human rights impacts may also have a material impact on its business by undermining or eliminating the company's ability to conduct business through a social license to operate.

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https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-non-financial-reporting-guidelines-consultation-document_en.pdf.

[16] *See* ICAR, Knowing and Showing, *supra* note 1 at 25; E&Y & Boston College Center for Corporate Citizenship, Value of Sustainability Reporting, *supra* note 2, at 2; *see generally* Economist Intelligence Unit, Corporate Citizenship: Profiting from a Sustainable Business (2008), http://graphics.eiu.com/upload/Corporate_Citizens.pdf .

[17] Salil Shetty, "Thirty years on from Bhopal disaster: Still fighting for justice," Amnesty International (Dec. 2, 2015), https://www.amnesty.org/en/latest/news/2014/12/thirty-years-bhopal-disaster-still-fighting-justice/.

[18] Alan Taylor, "Bhopal: The World's Worst Industrial Disaster, 30 years later," The Atlantic (Dec. 2, 2014), http://www.theatlantic.com/photo/2014/12/bhopal-the-worlds-worst-industrial-disaster-30-years-later/100864/.

[19] Max Nisen, "How Nike Solved Its Sweatshop Problem," BusinessInsider(May 9, 2013), http://www.businessinsider.com/how-nike-solved-its-sweatshop-problem-2013-5.

[20] Shelly Banjo, "Inside Nike's Struggle to Balance Cost and Worker Safety in Bangladesh," The Wall Street Journal, (Apr. 21, 2014), http://www.wsj.com/articles/SB10001424052702303873604579493502231397942 (citing a loss of $100 million to pull soccer balls made with child labor, and causing the company to cease operations for 18 months until it could fix the labor issues in its factory); Max Nisen, *supra* note 23.

While a range of reporting standards exist for voluntary disclosure of ESG information, the application and consistency of these standards varies greatly. This variability makes it difficult for investors to compare ESG data across companies or time, hindering the effectiveness of such disclosures for investment decision-making.[21] Without a regulatory mandate, voluntary disclosures are often incomplete, inconsistent, and not comparable. The SEC has recognized the value and importance of standardized disclosures for these same reasons.[22] When reporting becomes mandatory, standards necessarily become clearer, and the disclosed information more relevant and pertinent to investor needs. The United States risks falling behind the global curve in mandating the disclosure of ESG issues important to investor assessment of long-term profitability, and is now presented with an opportunity to do so. An opportunity it must capitalize on.

Please find included in this testimony ICAR's *Knowing and Showing* report, and two issue briefs entitled "Setting the Record Straight: Common Misconceptions about Environmental, Social, and Governance (ESG) Reporting" and "Why Enhanced Securities Disclosures Matter for Long-Termism."

Should you have any questions or wish to speak in further detail about my testimony, please do not hesitate to contact me at jana@icar.ngo.

Sincerely,

Jana Morgan
Campaigns and Advocacy Director
International Corporate Accountability Roundtable (ICAR)

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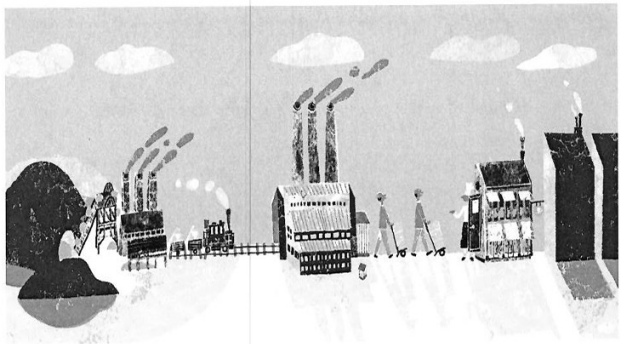
[21] *See, e.g.*, Jim Coburn & Jackie Cook, Cool Response: The SEC & Corporate Climate Change Reporting (2014), https://www.ceres.org/sites/default/files/reports/2017-03/Ceres_SECguidance-append_020414_web.pdf. *See also*, David Levy, Halina S. Brown, & Martin de Jong, The Contested Politics of Corporate Governance: The Case of the Global Reporting Initiative, 49 BUS. & SOC'Y 88 (2010); Carl-Johan Hedberg & Fredrik von Malmborg, The Global Reporting Initiative and Corporate Sustainability Reporting in Swedish Companies, 10 CORP. SOC. RESP. & ENVTL. MGMT. 153 (2003).

[22] *See* Chair Mary Jo White, Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility" (Dec. 9, 2015), https://www.sec.gov/news/speech/keynote-2015-aicpa-white.html.



"KNOWING AND SHOWING"

USING U.S. SECURITIES LAWS TO COMPEL HUMAN RIGHTS DISCLOSURE

A REPORT BY

THE INTERNATIONAL CORPORATE ACCOUNTABILITY ROUNDTABLE (ICAR)

ENDORSED BY

PROFESSOR CYNTHIA WILLIAMS

Endorsement

This document has been reviewed, edited, and endorsed by Professor Cynthia A. Williams.

Professor Cynthia A. Williams joined Osgoode Hall Law School on July 1, 2013 as the Osler Chair in Business Law, a position she also held from 2007 to 2009. Before coming to Osgoode, she was a member of the faculty at the University of Illinois College of Law and, prior to that, she practiced law at Cravath, Swaine & Moore in New York City.

Professor Williams writes in the areas of securities law, corporate law, corporate responsibility, comparative corporate governance, and regulatory theory, often in interdisciplinary collaborations with professors in anthropology, economic sociology, and organizational psychology.

Professor Williams' work has been published in the Georgetown Law Journal, the Harvard Law Review, the Journal of Corporation Law, Theoretical Inquiries in Law, the University of New South Wales Law Journal, the Virginia Law Review, and the Academy of Management Review.

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Amol Mehra, Esq.

Director, International Corporate Accountability Roundtable (ICAR)

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Introduction

After decades of economic globalization and trade liberalization, traditional legal and regulatory enforcement systems have proved to be inadequate in holding corporations accountable for the adverse social impacts of business activities. Due partly to limitations on courts' jurisdictional authority over extraterritorial activities of corporations[1] and weaknesses in the rule of law in operating jurisdictions,[2] corporations have functioned in an environment where regulations that are intended to hold them accountable for the way in which they conduct business are insufficiently enforced.[3] Yet, public reaction to recent corporate disasters such as the factory collapse at Rana Plaza in Bangladesh,[4] the adoption of socially responsible investment policies by a broad cross-section of investors,[5] and international policy convergence on the responsibility of businesses to respect human rights[6] all indicate that human rights concerns related to business activities are relevant and material to a broad set of stakeholders.

In recent years, public attention on business-related human rights abuses has grown in a wide variety of industries. Popular disapproval of corporate complicity in human rights violations has manifested in the form of direct boycotts by consumers, as well as pressure from an investor community that is increasingly interested in social issues. For instance, the garment industry has received widespread and largely negative attention after multiple deadly factory disasters in Bangladesh, including the Tazreen Fashions fire that killed 114 workers in Dhaka on November 24, 2012[7] and the Rana Plaza factory collapse on April 24, 2013 that left more than 1100 workers dead.[8] In addition, the information and communications technology industry has struggled to effectively self-regulate and monitor labor standards in its supply chains, as demonstrated by the frequent publicity surrounding the harsh conditions facing workers at the FoxConn factory complex in China.[9] The extractives industry has similarly faced scrutiny for adverse working conditions, human rights abuses by security personnel at mines,[10] forced labor and other modern forms of slavery,[11] and the contamination of ground water supplies.[12]

In response to these types of incidents, consumers have increasingly taken direct action to boycott and encourage divestment from socially irresponsible companies.[13] Certification labels such as "Rainforest Alliance"[14] and "Fair Trade"[15] have become sought after by companies in order to market their products to socially-motivated purchasers. Moreover, investors are adopting socially responsible policies to guide their decisions and are expecting valuable returns on their outlays as a product of doing so, as indicated by the rising asset values of socially responsible investment funds in the United States over the past two decades (from $639 billion in 1995 to $3.74 trillion in 2012).[16] Mainstream institutional investors, including institutional mutual and equity funds, have also signed onto international principled investing standards, joining more than 1188 signatories to the United Nations Principles for Responsible Investment—altogether commanding a total of more than $34 trillion (or over 15% of the world's investable assets) in market capital.[17]

A company's reputational risk—the material damage to a company's reputation as a result of social missteps—can therefore result in significant business costs. As has been shown in a multitude of instances, consumer and client preferences can change dramatically upon the discovery of human rights risks. Employees, recruits, investors, and shareholders alike may seek to disassociate from a corporation that is implicated in human rights violations. This ripple effect from the discovery of human rights risks and impacts can negatively alter any competitive advantages that a business might have because of changes in public perception. For example, the rise in popularity of "fair trade" coffee illustrated this effect when major coffee shops faced backlash and demands from customers before agreeing to serve fair trade certified coffee.[18] Now, more than ever, consumers and investors are making the conscious decision to purchase from and invest in companies that utilize an ethical supply chain and are not complicit in human rights violations. As such, companies should reasonably expect consumers and investors to prefer and even demand complete and accurate information concerning human rights risks before making the decision to purchase or invest.[19]

In the absence of enforceable and uniform regulations for corporate accountability at the global level, domestic law must work to answer this call for corporate accountability. U.S. securities regulation is a key and promising area for such domestic efforts as it is based on a philosophy that uses transparency to allow market actors to hold corporations accountable for social conduct and standards.[20] This paper applies that purposeful logic to provide a road-map for how U.S. securities laws can be used to create conditions for investors to hold companies accountable for their social and human rights impacts. Market actors can and should motivate companies to act more responsibly regarding their impact on human rights by allocating capital resources to more responsible companies. However, market actors can only do so if there is transparent, clear, and comparable disclosure of those human rights risks and impacts, as well as the policies and procedures that are related to the assessment and management of such risks and impacts.

This paper argues that human rights are materially relevant to corporate securities reporting and encourages the U.S. Securities and Exchange Commission (SEC) to guide businesses in reporting material human rights information in their periodic and proxy disclosure reports. First, the paper outlines the legal framework for securities disclosure regulations that are relevant to human rights. Second, the paper explains the methodology for assessing whether information related to corporate activities is material and uses this methodology to analyze whether human rights information is material to corporate securities disclosures. Finally, the paper proposes a plan for implementing disclosure of material human rights information related to business activities, incorporating human rights due diligence standards at the global level to assess and identify material human rights risks and impacts.

As part of this proposed plan, this paper identifies two alternative and complementary actions that the SEC could take to clarify precisely how issuers should disclose material human rights information. First, given its authority to issue interpretive guidance, the SEC should provide such guidance in order to explain how material human rights information should be incorporated into

existing securities reporting items. Second, given its authority to promulgate new regulations for the public interest or the protection of investors,[21] the SEC should promulgate a new rule specifically requiring disclosures of human rights information, organized in a new reporting item for periodic reports or proxy disclosures. Interpretive guidance would facilitate mandatory reporting under existing rules by clarifying the materiality of human rights information to investors, whereas a new rule could establish clear and organized disclosure of human rights matters in a new reporting item, enabling investors to easily review this information in their capital allocation decisions.

The Legal Framework: U.S. Securities Reporting Standards

The SEC was established by the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").[22] Its mission is to promote the public interest by protecting investors, facilitating capital formation, and maintaining fair, orderly, and efficient markets.[23] More recently, the Sarbanes-Oxley Act of 2002[24] and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[25] were passed in response to accounting scandals and securities market abuses that destabilized the domestic and global economy, further impacting the SEC's mission and mandate.[26]

The intellectual architects of the U.S. securities regulation system favored the use of transparency as a regulatory mechanism, not only to ensure accurate pricing of securities in the marketplace,[27] but also to motivate changes in business behaviors by exposing corporate conduct to public scrutiny.[28] Based on this foundational architecture, transparency became one of the primary mechanisms for implementing the investor protection and public interest purposes of U.S. securities regulations.[29] The debates within the U.S. House of Representatives on both the Securities Act and the Exchange Act clearly indicate that public disclosure of information was intended to affect the way business is performed, including in ways that increase the social responsibility of business conduct.[30]

This section will outline the legal framework of securities law in the United States. Corporate securities reporting essentially involves two steps: (1) identifying and collecting the type of information required for disclosure under securities regulations and (2) filtering that information by determining what is "material" for disclosure to the SEC, investors, and shareholders.

A. The Disclosure Provisions

Securities-issuing entities are required to publicly report information to enable investors and shareholders to make informed investment decisions and allocate capital resources efficiently. Under U.S. securities law, issuers must disclose information publicly to the SEC at the following regular intervals: (1) at the initial public issuing of securities, (2) at registration of securities, (3) at quarterly and annual periodic intervals, (4) as part of proxy solicitation disclosures for the annual shareholders meeting, and (5) at the occurrence of extraordinary events such as a tender offer, merger, or sale of the business.[31] The integrated disclosure requirements for registered securities are organized in the comprehensive Regulation S-K (or Regulation S-B for small businesses).[32] Additionally, shareholders have the authority to demand disclosures beyond those required under Regulation S-K by using their power to bring resolutions during the proxy solicitation process for annual shareholders meetings.[33] These regulations are buttressed by a number of other rules: (1) Rule 408, promulgated pursuant to the authority of the Securities Act, and Rule 12b-20 of the Exchange Act, both of which require additional disclosure of material

information necessary to ensure that required disclosures are not misleading,[34] and (2) Rule 10b-5, promulgated pursuant to the authority of Section 10(b) of the Exchange Act, which establishes legal liability for those responsible for fraudulent or untrue statements or omissions in disclosures connected with the purchase or sale of securities.[35]

In order to ensure that the information disclosed in securities reports is useful to investors, issuers are only required to report information that is "material" to the users of their reports.[36] In the case of periodic securities reports, the intended users are potential investors and existing shareholders. Materiality is both an accounting and securities law concept for classifying information as significantly relevant to understanding the past, current, and future value and performance of the issuer's securities. It is judged based on factoring the quantitative and qualitative importance of the information in evaluating the issuer and in relation to the intended users of the report.[37] For securities reports, information must be disclosed that is: (1) specifically required under Regulation S-K or necessary to ensuring that required disclosures are not misleading[38] and (2) material to investors' or shareholders' decision-making processes in accurately valuing securities, in particular for the purpose of choosing to buy or sell securities.[39]

I. Regulation S-K and Periodic Disclosure of Non-Financial Information

Regulation S-K outlines the standard instructions for corporate securities disclosures required by U.S. securities regulations. These regulations inform the initial obligation to disclose specific types of information in prospectuses for the sale of new securities, in companies' periodic and extraordinary occurrences reports, and in companies' proxy statements in conjunction with their annual meeting. In addition to a company's registration statement, there are four primary categories of disclosures for periodic reporting, including descriptions of the registrant's (1) business, (2) securities, (3) financial information, and (4) management.[40] Issuers are required to provide periodic disclosures quarterly on the SEC's Form 10-Q and annually on the Form 10-K.[41]

Several provisions of Regulation S-K require descriptive disclosures that may incorporate material non-financial information. Key provisions that require discussion of non-financial information include Item 101 (description of business), Item 103 (legal proceedings), Item 303 (management's discussion and analysis), Item 307 (disclosure controls and procedures), and Item 503(c) (risk factors).[42] The SEC occasionally issues interpretive guidance releases to clarify the information issuers are expected to disclose and how the Commission staff evaluates disclosures by issuers.[43]

Description of Business, Item 101

The description of business under Item 101 should indicate general developments in the business during the previous five years, including any material changes in the mode of doing business and a forward-looking description of the plan of operation for the next reporting period.[44] Depending on the timing of the report, projections must outline the plan for the remainder of the fiscal year or for that period and an additional six-months into the next fiscal year.[45] This item includes three primary disclosures: (1) general development of business, (2) financial information about business segments, and (3) a narrative description of business.[46]

The narrative description of business requires disclosures encompassing all areas of the business operations. An issuer must disclose the principal products and services involved in the issuer's business, the status of each business segment or new product (e.g. planning, prototype, design-selection, re-engineering stages), the sources and availability of raw materials, the status and importance to the business valuation of all intellectual property, and the extent to which business segments are or may be seasonal in nature.[47] There must be a description of the principal methods of competition and positive and negative factors related to the issuer's competitive position should be reported.[48] Finally, material effects on capital expenditures from compliance with federal, state and local provisions related to environmental protection must be explained appropriately.[49]

Legal Proceedings, Item 103

Under Item 103, issuers must disclose information relating to any pending legal proceedings involving the issuer, any of its subsidiaries, or any of their property as a party to litigation where the proceedings could have a material impact on the issuer.[50] This reporting requirement is limited in scope by the qualifications that pending litigation must be other than routine litigation incidental to the business, and it must have the potential to result in damages exceeding ten percent of the issuer's current assets.[51] Where several cases based on the same legal or factual issues are pending or are being contemplated, the amount of potential damages must be calculated by aggregating the claims.[52] These limitations do not directly apply where the proceeding arises from a law or regulation for the purpose of environmental protection or where a governmental authority is a party to the proceeding and it involves potential monetary sanctions of more than $100,000.[53] In each of these cases, an issuer may only limit their reports if the proceeding's outcome is immaterial to the business or financial condition of the issuer or if the penalty where the government is a party is unlikely to be an actual fine of $100,000 or more.[54]

Management's Discussion and Analysis, Item 303

Management's Discussion and Analysis ("MD&A") under Item 303 is intended to provide a narrative description of management's views concerning the financial condition of the company and the results of business operations, with a particular emphasis on future prospects and risks.[55] This section should add value to the overall disclosures provided by the company and supply a contextual basis for investors to analyze financial information.[56] To do so, the MD&A must include reporting covering three subjects: liquidity, capital resources, and results of operations. Detailed instructions of explicit requirements in discussing each of these subjects are found in Instruction 5 to Item 303(a).[57] Essentially, the reporting requirements focus on management identifying any known trends, events, or uncertainties that will or are "reasonably likely" to result in favorable or unfavorable material effects to the issuer's liquidity, capital resources, or operating results—such as net sales, revenues, or costs from continuing operations.[58] These disclosures are intended by the SEC to be made in a meaningful, company-specific manner and should not use "boilerplate" phrasing and generalities.[59]

Disclosure Controls and Procedures, Item 307

Item 307 requires an issuer's principal executive or financial officers, or the functioning equivalent, to disclose their conclusions regarding the effectiveness of internal disclosure controls and procedures.[60] This will require a short, narrative explanation of the executives' understanding of the internal processes and an affirmation of the effectiveness of the procedures that are in place. Generally, this will require disclosure outlining the due diligence and auditing measures the company uses to identify, assess, and evaluate required categories of information in preparation of the annual, quarterly, and special reports required by securities regulations.

Risk Factors, Item 503(c)

Item 503 is specific to prospectus disclosure as initially promulgated, but is recently incorporated into Item 1A for quarterly and annual reporting. In Item 503, the issuer is required to briefly summarize their prospectus in plain English, including a distinct section captioned "Risk Factors" to discuss the most significant factors that make the offering speculative or risky.[61] This typically includes risks of changes in the competitive landscape or market demand, fluctuations in political stability or other operating conditions, climate change risks and associated cost increases, and other such unpredictable variations in the business environment that may damage capital formation or financial performance.[62] This narrative discussion is specifically required to be "concise and organized logically," with risks presented that are tailored to the specific issuer

and their business.[63] It must be placed immediately following the summary section or any price-related information or directly after the cover page, if there is no summary.[64]

The risk factor discussion must explain how the risk affects the issuer and clearly express each risk factor in a sub-caption that adequately describes the risk.[65] The description of Item 503(c) in Regulation S-K specifically identifies risk factor categories in a non-exhaustive list, including lack of an operating history, lack of profitable operations in recent periods, financial position, business or proposed business, and the lack of a market for the issuer's common equity securities. The list provided is suggestive, but item 503(c) is clear that all of the most significant factors that make the offering speculative or risky must be disclosed.[66]

II. Shareholder-Demanded Disclosure Using Shareholder Resolutions, as Permitted Under Exchange Act Section 14(a), Regulating Proxy Solicitations and the SEC's General Powers Under Section 14(a)

Company-specific disclosure may also arise based on a successful shareholder resolution (also called shareholder proposals). Under state corporate law, securities owners have the power to put appropriate items on the annual meeting agenda. In Section 14(a) of the Exchange Act, the SEC is given general authority to regulate the process of soliciting proxies in conjunction with the annual meeting. In Rule 14a-8, the SEC has identified the procedural and substantive requirements for shareholders' resolutions. If a shareholder resolution asking for information from the issuer receives majority support in the proxy solicitation process, then the information may be forthcoming.[67]

Companies may seek a no-action position from the SEC staff to protect them from later SEC enforcement action if the company decides not to include certain shareholder resolutions in the company's annual proxy statement. Permissible reasons to exclude shareholder proposals are set out in Rule 14a-8, question 9.[68] Exclusion may be permissible based on the proposal violating one of the eligibility or procedural requirements of Rule 14a-8 or if it falls within one of the rule's thirteen substantive bases for exclusion.[69] If there is no basis to exclude a shareholder proposal, the issuer must include the proposal in its proxy solicitation for shareholders to consider.

Additionally, under the broad authority delegated to the SEC by Section 14(a) of the Exchange Act, the Commission is entitled to regulate the proxy solicitation process "as necessary or appropriate in the public interest or for the protection of investors."[70] It has been argued that this mandate was intentionally designed to allow the SEC to establish rules that would permit shareholders to hold companies accountable for their actions, including by promulgating proxy disclosure rules that would provide shareholders with more information about the companies' actions.[71] The challenge for any proponent of new proxy disclosure rules lies in gaining

sufficient support for any proxy disclosure request in order to instigate the SEC rule-making process under section 14(a).

III. Rules 408 and 10b-5: Ensuring Completeness, Accuracy, and Responsibility in Disclosures

Supplementary provisions of the Securities and Exchange Acts buttress the specific disclosure requirements in Regulation S-K. First, Securities Act Rule 408 and Exchange Act Rule 12b-20 provide a "catch-all" requirement to disclose any further material information necessary to ensure the overall disclosures are not misleading.[72] Then, Rule 10b-5 attaches personal liability for fraud, misstatements, or omissions to the individuals responsible for preparing and certifying the disclosures as true, accurate, and complete. These provisions act to complement disclosure requirements and ensure that managers and internal reporters have incentives to ensure that the information they are disclosing is complete, accurate, and true.

According to Securities Act Rule 408 and Exchange Act Rule 12b-20, issuers are required to add any material information necessary to ensure their disclosures are not misleading. The specific language of both Rule 408 and Rule 12b-20 require "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."[73] These rules act as a "catch-all" to ensure that issuers are required to disclose any additional material information necessary to ensure that information disclosed is not misleading—in essence, to guard against half-truths.

Section 10(b) and Rule 10b-5 of the Exchange Act create liability for using deceptive or manipulative devices in connection with the purchase or sale of securities.[74] In particular, according to Rule 10b-5 (b) it is unlawful for any person to directly or indirectly "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security."[75] This liability, in relation to periodic securities disclosures, attaches to the individuals involved in preparing the statements of material fact and to those who are required to certify that the material statements of fact are true and complete—usually the Chief Executive Officer, Chief Financial Officer, or similarly empowered high-level executive. This liability applies to materially misleading statements even where there is no affirmative duty to disclose such information.[76]

In making a claim for violation of Rule 10b-5, the plaintiff must prove several elements. They must show: (1) that the defendant is subject to Rule 10b-5, (2) that there was a misrepresentation or omission, (3) of a material fact, (4) made with the intent to deceive or recklessness in the misstatement, (5) upon which the plaintiff relied, (6) in connection with either a purchase or sale of a security (7) causing (8) damages.[77] While reliance is a part of the plaintiffs' case, it may be presumed in certain cases. In omission cases, reliance may be presumed if the omission is of a

material fact, and in misstatement cases there is a rebuttable presumption of reliance when the security is trading in an efficient market since the misstatement will operate as a "fraud on the market," affecting the market price.[78] Therefore, incentives are created to promote accuracy and completeness in periodic disclosures in part because the individuals responsible for preparing the information and certifying the disclosures may be personally liable for any fraudulent material inaccuracies or omissions.

B. What is "Material" for Corporate Disclosures?

The first part of the disclosure process involves collecting information based on the items specifically required under Regulation S-K, any information demanded by successful shareholder disclosure proposals, and the blanket requirements to include additional material information as necessary to ensure the disclosures are not misleading. Once this information is gathered, the issuer must determine what information is "material" and thereby subject to public disclosure and what information is immaterial and thereby not required to be disclosed publicly.[79] The second part of the disclosure process requires a subjective filtering of information related to required disclosure items through a screen of materiality, with the goal of ensuring that public disclosures are useful to investors and shareholders in assessing current and prospective corporate performance.

The Supreme Court of the United States has laid out a clear legal standard for identifying what is "material" for securities reporting. The standard is driven by the rationale behind the Securities Acts to "substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."[80] It is tempered by the judicial concern that "a minimal standard might bring an overabundance of information within its reach,"[81] and lead management to overburden the market with disclosures that did not enable "informed decision-making."[82]

A fact is material if "there is a substantial likelihood that a reasonable investor would consider it important" and would have viewed the information "as having significantly altered the 'total mix' of information made available."[83] The Court explains that assessing whether a fact is material "requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him."[84] Whether a fact is material "depends on the significance the reasonable investor would place on the . . . information."[85]

Regarding speculative or contingent information, including much forward-looking information, Supreme Court precedent calls for companies to balance "the indicated probability the event will occur and the anticipated magnitude of the event in the light of the totality of company activity."[86] Adopting the reasoning from earlier cases, the Court expects the significance of each fact to be assessed in relation to all other available information.[87]

The SEC has provided additional guidance in recent years to assist companies with determining materiality. In Staff Accounting Bulletin No. 99 ("SAB 99"), the SEC clarifies that materiality cannot be determined based on a bright-line quantitative criterion alone and that even information that is purely qualitative could, in the context of all other available information, be material to corporate securities disclosures.[88] In particular, SAB 99 dispelled the popular rule-of-thumb that any fact which could not result in a financial impact of at least 5% on any quantitative category was not material.[89] SAB 99 provided some guidance for accountants to consider qualitative characteristics in determining materiality by listing hypothetical situations where qualitative information would be considered material by SEC staff.[90]

Materiality determinations require the accountants and managers preparing securities reports to assess the qualitative and quantitative characteristics of information to identify information that a reasonable investor would consider important enough to significantly alter the "total mix" of information available.[91] The certainty or uncertainty of a fact, trend, or event's occurrence—and the nature and scope of the impact on corporate performance of that occurrence—will all affect whether it is material.[92] These subjective determinations should be guided by balancing the purposes of securities regulation in providing sufficiently accurate, detailed, and comparable information to protect investors and ensure fair, orderly, and efficient markets against a judicious temperance to refrain from overwhelming the market with a flood of useless information.[93]

Demonstrating Materiality: Human Rights Impacts, Risk Assessments, and Procedures Are Material for Corporate Securities Disclosures to the S.E.C.

Materiality derives from the general public, international and national governments, and businesses treating a particular area or impact of business activity with heightened interest.[94] In 2010, the SEC re-evaluated the materiality of information related to climate change in light of increasing interest from the public, academics, businesses, domestic and international government, and other stakeholders.[95] In doing so, the Commission outlined the process for considering whether a topic has become popularly relevant to the level of "material" to corporate reporting. Key factors considered include: heightened public interest in recent years (including academic, government, business, investors, analysts, or the public at large); international accords and efforts to address a topic of concern on a global basis; federal regulations or state and local laws in the United States; and voluntary recognition of the current and potential effect of the category of information on companies' performance and operations by business leaders.[96] The SEC addresses these key factors by analyzing the level of interest in climate change according to three primary elements: (1) recent regulatory, legislative, and other developments; (2) the potential impact of climate change related matters on public companies; and (3) current sources of climate change-related disclosures regarding public companies.[97] Within each element, the materiality of any category of information is supported by trends of public interest, international community action, domestic legislative action, and voluntary business action expressing an acknowledgment of material significance.

This section provides evidence that the significance of human rights information to investors and the public has evolved to a level that requires its disclosure as material information in securities reports. First, recent regulatory, legislative, and other developments in the US and international spheres are presented. Second, the potential impacts of human rights-related matters on public companies are outlined using examples from recent years. Finally, current sources of human rights-related disclosures regarding public companies are outlined. This evidence supports the conclusion that human rights are material to investors. Securities regulations must recognize this materiality by providing guidance for issuers to disclose information related to human rights risks and impacts in a clear, consistent, and comparable manner in their reports to the SEC.

A. Recent Regulatory, Legislative, and Other Developments

Legislators, regulators and international policy-makers have indicated that the human rights risks and impacts arising from globalized business activities require concerted global action. Domestic

legislators and regulators in the United States have adopted public policies and rules at the federal, state, and local levels that address corporate social responsibility and enhance corporate transparency relating to human rights.[98] The international community has endorsed defined roles for States and businesses in the UN's "Protect, Respect, Remedy Framework"[99] and the "Guiding Principles" for implementing this framework in the business and human rights context.[100] Furthermore, the United States government has endorsed the Guiding Principles and has been encouraged by members of civil society to develop a plan for national implementation.[101] Stakeholders in business and civil society have come together with initiatives to develop particular standards and processes for addressing human rights risks and impacts through voluntary action.[102]

I. Federal Government Regulatory Efforts

Federal legislators and administrative agencies in the United States have used their authority to promote corporate respect for human rights and to provide greater transparency to investors and the public on human rights risks and impacts related to business activities. In the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Congress required transparency from companies in special securities disclosures to address corruption and bribery, mine safety, and conflict minerals sourcing.[103] The SEC interpretive guidance for disclosures related to climate change[104] and to cyber-security information[105] has directed companies to disclose socially important information similar to human rights concerns under existing securities disclosure rules in Regulation S-K. Finally, the State Department issued rules requiring transparency for new investments in Burma in May 2013.[106]

Dodd-Frank Special Disclosure Provisions

In the Dodd-Frank Act of 2010, the U.S. Congress employed the mechanism of securities disclosures to require transparency regarding mine safety,[107] payments by resource extraction companies to governments,[108] and supply chain due diligence by manufacturers who source minerals from the Congo region of Africa.[109] These provisions directed the SEC to issue rules requiring issuers to disclose information related to these three activities with the apparent goals to enhance awareness about dangerous mining conditions, combat corruption in foreign governments, and eliminate funding for armed groups perpetuating conflict and human rights violations in the Congo.[110] Although Congress determined that these purposes fit within the mandate of the SEC, some observers have questioned the role of the SEC in compelling disclosures of this information and the materiality to investors.[111] Investors, meanwhile, have commented on the rule-making processes for each section and provided considerably favorable

feedback as they seek access to information regarding the social and human rights impacts of business activities of issuers conducting operations in conflict-affected and weak governance areas.[112]

Section 1502 of the Dodd-Frank Act mandates that the SEC issue a rule requiring companies to determine whether certain minerals used in the production of their manufactured goods originated in the Democratic Republic of Congo (DRC) or neighboring countries and whether the trade in those minerals has financed or benefitted armed groups. The SEC rule implementing Section 1502 requires companies that file reports with the SEC to determine whether they source designated minerals from this region. If they do, and those minerals are necessary to the functionality of the manufactured goods they are used to produce, the company should be required to conduct supply chain due diligence to determine whether their mineral purchases are providing funding directly or indirectly to armed groups perpetuating conflict and violence in the DRC. [113] As part of the required disclosures, companies must describe the specific measures taken to exercise due diligence.[114] The rule follows a "comply or explain" philosophy, requiring companies to comply and show their efforts or explain their non-compliance and show what efforts they have undertaken to comply.

Section 1503 of the Dodd-Frank Act calls for the SEC to require specific periodic disclosure by issuers operating coal or other mines of information detailing health and safety violations or a pattern of such violations in their operations.[115] The SEC rule implementing this disclosure is based on the Federal Mine Safety and Health Act of 1977 (Mine Safety Act) and expands the level of detailed information about mine safety issues that must be publicly disclosed.[116] This rule requires issuers to report the receipt of certain notices from the Mine Safety and Health Administration (MSHA) on current report disclosure Form 8-K, which must be filed within four business days of specific material events to provide an update to quarterly or annual reports.[117] Further, the rule requires that quarterly and annual reports include aggregated totals for: (1) health and safety violations, orders, or citations under the Mine Safety Act; (2) the potential costs of proposed assessments from the MSHA under the Mine Safety Act; and (3) mining-related fatalities during the reporting period.[118]

Finally, Section 1504 authorizes the SEC to demand resource extraction companies disclose any and all payments made to domestic or foreign government officials. Under this requirement, companies are expected to submit information to the SEC in interactive data format, detailing: (1) total amounts of payments by category, (2) the business segment that made the payments, (3) the government that received the payments, (4) the country in which they are located, and (5) the project of the issuer to which the payments relate.[119] The SEC is given authority to require any other information considered "necessary or appropriate in the public interest or for the protection of investors."[120] This rule may be limited by a *de minimus* exemption, allowing companies to refrain from disclosing very minimal payments, but the statute indicates the Commission should be guided in its rulemaking by the guidelines set out in the Extractive Industries Transparency

Initiative—a voluntary international multi-stakeholder initiative for extractive companies and governments to publish payments made and received related to resource extraction projects.[121]

Critics of these specialized disclosure requirements argue that they go beyond the scope of the SEC's authority by targeting public policy goals unrelated to investor protection, market efficiency, or capital formation.[122] They argue that the original purpose of the SEC is being manipulated for federal policy-making goals because the SEC is the only regulatory body capable of commanding regulatory compliance across all industries.[123] However, these criticisms appear to fail to consider the legislative mandate to the SEC to regulate "as necessary or appropriate in the public interest or for the protection of investors," as in Section 14(a) of the 1934 Act.[124] These criticisms also fail to consider the legislative history describing the original intended purposes of federal securities regulation, which have been argued to include establishing greater social responsibility in corporate conduct.[125] Congress has the authority to mandate rulemaking on specific items where it is deemed in the public interest.[126] Further, investor groups have actively advocated for the materiality of the information to be disclosed under these provisions for their decision-making processes.[127]

SEC Guidance on Climate Change and Cyber-Security

The SEC has recently been engaged in clarifying the disclosure requirements of non-financial information related to climate change and cyber-security in securities reports. Each of these releases has indicated how existing securities regulations may require disclosure of information related to climate change or cyber-security matters where they are material to the issuer or any of its business segments.[128] Both discuss how the costs of compliance with laws and regulations to prevent and mitigate risks related to climate change or cyber-security may result in material expenses necessary to report in financial disclosures. Further, both detail how the description of business, legal proceedings, MD&A, and risk factors items in Regulation S-K may compel issuers to address cyber-security or climate change risks or incidents.[129] The climate change guidance identifies specific provisions in Regulation S-K that have been enacted during the past four decades of rulemaking and interpretive guidance on disclosures related to environmental protection or climate change matters.[130] The cyber-security guidance also details how the disclosure controls and procedures section may require disclosure of the effectiveness of cyber-security measures or any deficiencies that could render them ineffective.[131]

State Department Responsible Investment in Burma Reporting Standards

The U.S. Department of State recently released their Responsible Investment Reporting Requirements for all U.S. businesses investing more than US$500,000 in Burma, effective May

23, 2013.[132] Companies must publicly provide summaries or copies of the policies and procedures relating to operational impacts on human rights, community and stakeholder engagement in Burma, and grievance processes.[133] They must outline their human rights, worker rights, anti-corruption, and environmental due diligence policies and procedures, including those related to risk and impact assessments.[134] Further, they must report to the State Department their policies and procedures relating to security service provision and military communications.[135]

Foreign Corrupt Practices Act

Congress has been involved in regulating corporate conduct in transactions and business activities abroad at least since 1977, when it passed the Foreign Corrupt Practices Act[136] (FCPA), prohibiting the use of bribery to foreign government officials to assist in obtaining or retaining business.[137] The prohibition of promises, offers, or payments of bribes to foreign officials applies anywhere in the world and extends to public companies and their officers, directors, employees, stockholders, and agents—including consultants, distributors, joint-venture partners, and others.[138] The FCPA also requires that issuers (1) make and keep books and records that accurately reflect the corporation's transactions and (2) put in place a system of internal accounting controls to adequately oversee and account for corporate assets and transactions.[139] These records and internal controls help the issuer identify, prevent, mitigate, and remedy any offending conduct.

II. State and Local Government Regulations or Laws

States have the primary legislative authority to regulate corporate governance and liability in U.S. law. Several states have engaged their legislative authority or are considering laws to address human rights risks and impacts arising from business activities. In 2011, California became the first state to pass a law preventing companies under scrutiny for ineffective compliance with the Dodd-Frank conflict minerals supply chain reporting requirements from eligibility to bid on state procurement contracts.[140] Maryland passed a similar law in 2012, and Massachusetts is presently considering legislation to follow suit.[141] Additionally, California has enacted the Transparency in Supply Chains Act of 2010, requiring transparency related to corporate efforts to monitor supply chains to combat slavery or human trafficking.[142] Through these laws, legislators in California, Maryland, and Massachusetts are clearly indicating that they are interested in holding corporations accountable for their conduct abroad, including the direct or indirect financing of conflict and crimes against humanity in their supply chains for mineral resources.

III. International Community Actions to Address Business and Human Rights Concerns on a Global Basis

The international community has taken actions at several levels to address business and human rights concerns on a global basis. The United Nations has engaged stakeholders and developed frameworks for global action through defined roles of governments and businesses in upholding human rights, standards for responsible and principled investing, and guiding principles for businesses to implement their responsibilities to respect human rights.[143] International organizations such as the Organization for Economic Co-operation and Development ("OECD") and the International Organization for Standardization ("ISO") have also released guidelines for businesses to implement their social and human rights responsibilities that incorporate and expand upon the standards of the Guiding Principles.[144] The European Union is currently preparing legislation to require corporations to publicly disclose information related to human rights and other non-financial social and environmental impacts of business activities.[145] Additionally, businesses, governments and civil society groups have come together voluntarily in multi-stakeholder initiatives ("MSIs") to address particular concerns and create best practices approaches in the form of standards and mechanisms to protect against adverse human rights risks and impacts of business activities.[146] Each of these international mechanisms will be discussed in turn.

UN Frameworks and International Standards

The United Nations has progressed from voluntary multi-stakeholder initiatives—such as the UN Global Compact[147]—to consultative approaches seeking to develop international standards that can be incorporated into domestic laws and that follow the "Protect, Respect Remedy" Framework[148] and the Guiding Principles for Business and Human Rights.[149] These frameworks provide a "common global platform for action" for governments and businesses to act to prevent and remedy adverse human rights risks and impacts related to business activities and operations.[150] The OECD has provided insight and standards with its Guidelines for Multinational Enterprises (OECD Guidelines),[151] and the ISO has introduced direction with its Standard 26000 for "Social Responsibility."[152]

The UN Global Compact was launched in July 2000 as a "platform for the development, implementation, and disclosure of responsible and sustainable corporate policies and practices."[153] It is a voluntary initiative which calls on corporations and interested stakeholders to join the Compact and commit to embracing, supporting, and enacting—within their spheres of influence—its Ten Principles, covering human rights, labor, environment, and anti-corruption standards.[154] The Ten Principles are derived from the Universal Declaration of Human Rights, the International Labour Organization's Declaration of Fundamental Principles and Rights at

Work, the Rio Declaration on Environment and Development, and the UN Convention Against Corruption.[155] Since its inception, it has grown to contain over 10,000 corporate participants and to include stakeholders from over 130 countries.[156]

Building from the "Protect, Respect, Remedy" framework that was passed in 2008, the UN Special Representative on Business and Human Rights developed the Guiding Principles on Business and Human Rights.[157] The Guiding Principles provide a "common global platform for action, on which cumulative progress can be built" towards realizing the protection of, and respect for, human rights through State and business actions.[158] They are a series of 31 practical principles to guide the implementation of the State duty to protect human rights, the business responsibility to respect human rights, and the provision of access to remedy for human rights abuses and violations.[159] Businesses are encouraged to apply these principles appropriately according to their size, complexity, and operating contexts to ensure that they are respecting human rights.[160]

In particular, the Guiding Principles call for businesses to adopt policies and build a corporate culture that respects human rights. They are advised to do this by implementing human rights due diligence processes to identify, prevent, mitigate, and account for how they address adverse human rights impacts arising from their business.[161] This due diligence should include "assessing actual and potential human rights impacts, integrating and acting upon the findings, tracking responses, and communicating how impacts are addressed."[162] Businesses are advised to engage with stakeholders throughout the process and to be prepared to communicate their human rights impacts externally when concerns are raised or when risks of severe human rights impacts are identified.[163]

Additionally, the UN has developed widely accepted Principles for Responsible Investing ("UN PRI"). These principles were launched in 2006 and now have almost 1200 investor signatories, with assets under management standing at more than $34 trillion—or more than 15% of the world's investable assets.[164] The rapid growth of the UN PRI shows that investors—in particular large, institutional investors—are quickly integrating responsible investment policies and criteria into their decision-making calculus. The UN PRI emphatically believes that environmental, social, and governance issues are materially relevant to investors and, although it recognizes the limitations of available research data, it is firm in its confidence that these issues are financially significant.[165]

The OECD Guidelines for Multinational Enterprises ("OECD Guidelines") provide a set of non-binding principles and standards for responsible business conduct in the global context that follow applicable local laws and internationally recognized standards.[166] These standards are implemented through the National Contact Points (NCPs) mechanism, which are government agencies tasked with promoting the OECD Guidelines and assisting MNEs and their stakeholders in implementing the standards.[167]

Under the Guidelines, MNEs are required to disclose material information regarding their: (1) policies and codes of conduct; (2) performance in relation to those statements and codes; (3) internal audit, risk management, and legal compliance systems; and (4) relationships with workers and other stakeholders.[168] The "Commentary on Disclosure" indicates that the purpose of transparency should be to address the increasingly sophisticated public demands for information, including social, environmental, and risk reporting.[169] The 2011 edition of the Guidelines aligns its human rights standards with the UN Framework and Guiding Principles.[170] They require companies to "respect human rights" through: (1) policy commitments; (2) actions to prevent or mitigate adverse human rights impacts directly linked to their operations, products, or services; (3) carry out human rights due diligence appropriate to their circumstances, and (4) empower legitimate processes for the remediation of human rights impacts where they are implicated.[171]

The OECD has developed sector-specific standards in the Due Diligence Guidance for Responsible Supply Chains from Conflict-Affected and High Risk Areas[172] (OECD Due Diligence Guidance). The OECD Due Diligence Guidance provides a five-step process for companies to conduct due diligence, undertake risk assessments, mitigate and monitor risks in the supply chain, and participate in audit programs for external, independent assurance.[173] Finally, the process requires annual disclosure of risk assessment reports, detailed descriptions of how due diligence processes have been reviewed and verified, and what steps are taken to regularly monitor changing circumstances of supply chains.[174]

The ISO has developed a standard to reflect consensus, state-of-the-art standard best practice for social responsibility to assist organizations in contributing to sustainable development.[175] Through a holistic approach that incorporates seven core subjects, the ISO 26000 standard provides practical guidance on how to adopt principles of social responsibility, recognize that responsibility, and engage with stakeholders to integrate that responsibility throughout an organization.[176] For human rights, ISO 26000 guides organizations to implement due diligence, monitor and mitigate risks, avoid complicity, and support the resolution of grievances.[177] It describes these issues in relation to broad categorization of human rights, including civil, political, economic, social, cultural, and labor rights.[178]

European Union Legislation

The European Commission (EC) has recently proposed a directive on non-financial disclosure requirements that would, in part, require corporations to report publicly their respect for human rights. The proposed standards would require companies to report relevant and material information on policies, results, risks, and risk management efforts pertaining to respect for human rights, as well as other environmental, social, and governance issues.[179] The proposal is currently awaiting a vote in the European Parliament, after which it would come into force in 18

months. At that time, EU member-state governments would be required to begin the process of implementing the standards into national domestic law. The actual standards of non-financial disclosure required regarding specific types of information may vary from State-to-State but the EU directive will provide the basic requirements.

Multi-Stakeholder Initiatives (MSIs)

There are a number of MSIs developed through business and civil society leadership to address sector-specific or issue-specific concerns relating to the intersection of business and human rights. Through these platforms, stakeholders have worked together to formulate strategies and exchange feedback to develop operational approaches to address adverse human rights risks and impacts. Examples of MSIs include the Extractives Industry Transparency Initiative ("EITI") and the Global Network Initiative ("GNI").

The EITI is a global standard to promote revenue transparency and accountability in the extractive sector.[180] It requires companies to report payments to governments and governments to disclose their receipts of payments to the EITI multi-stakeholder oversight group, which verifies and reconciles tax and royalty payments from resource extraction operations. A multi-stakeholder group representing business, civil society, and governments oversees the process and communicates the EITI Report findings.[181] The goal is that, by requiring both sides to transparently report their exchange, the independent verification will prevent under-reporting and combat corruption and bribery in resource rich countries with poor governance, which can often contribute to conflict and a high risk of human rights violations.[182] Governments are required to apply to be a member of EITI and must effectively implement all aspects of the EITI requirements in order to become a member.[183] Failure to effectively implement the requirements can result in EITI suspending operations, as recently occurred in the DRC.[184]

The GNI is a sector-specific, multi-stakeholder initiative for the information and communications technology ("ICT") industry that requires participating companies to implement its Principles on Freedom of Expression and Privacy to protect and advance the enjoyment of these human rights globally.[185] Implementation of the Principles includes a Governance, Accountability, and Learning process that requires participating companies to submit to independent compliance monitoring and transparent reporting that outlines compliance activities, results of independent assessments, impacts on freedom of expression and privacy, and the path forward.[186]

Recent legislative, regulatory, and other developments clearly indicate that policy-makers at the federal, state, and international levels are increasingly interested in taking action to address adverse human rights risks and impacts related to globalized business activities. Domestic legislators have enacted transparency requirements to address public interest in eliminating direct

or indirect support for corrupt governance, violent conflict, and human trafficking. International organizations have been engaged in creating consensus and global standards for business responsibilities related to human rights and have gathered global support for concerted action to implement those principles. Business and civil society actors have engaged with the international community to take direct action on specific concerns and in specific contexts through practical operational frameworks. Altogether, these recent developments indicate the increasing materiality of human rights-related matters to corporate activities.

B. Potential Impact of Human Rights-Related Matters on Public Companies

The "business case" for disclosure of human rights information rests on growing evidence that human rights performance has a real impact on long-term corporate value.[187] As investors learn how companies predict, mitigate, and manage risks and impacts, capital should be allocated efficiently to businesses with stronger capacities to overcome challenges. Therefore, in an efficient market, the potential direct and indirect impacts of human rights-related matters are material to investor decision-making.

Direct impacts—such as capital costs related to compliance with laws and regulations, financial penalties for non-compliance, or damages related to liability for abuses or violations—are material risks that affect the future corporate outlook. Indirect impacts—such as the market effects of rising supply chain costs, increasing prices of raw materials, or changes in the competitive advantage based on varying capability to attract and retain workers, customers, clients, or users—could materially affect corporate performance. Finally, political effects—arising from human rights risks and impacts connected to business activities, operations, or relationships—may have a material impact on business and the social license to operate.

I. Direct Impacts

Dealing with human rights-related matters directly impacts corporate performance through additional costs, changes in operating conditions, and unpredictable delays in production and revenue generation.[188] Investors are materially interested in the potential and actual costs that a company faces related to human rights risks and impacts because these directly impact corporate financial performance and securities valuations.[189] Where new laws or regulations add compliance requirements, there are costs associated with complying. Where a company is implicated in human rights abuses or violations, they will face costs in mitigating the impacts, additional expenses in public relations, and potentially for litigation, mediation, or some other grievance or remediation process. Where human rights abuses or violations occur in one operating context, a company may face extra costs in re-assuring its stakeholders that its other

operations are not subject to the risk of similar incidents. Based on the potential for these direct impacts—where a human rights risk or change in political environment resulting in stronger human rights regulation is a possibility—the expected direct costs of those eventualities are material to investors' valuations of securities.[190]

II. Indirect Impacts

The indirect costs related to human rights risks are more difficult to predict and are much more costly to business. These can arise in the form of reputational damage, changes in consumer preferences that alter the definition of competitive advantages in the marketplace, or unexpected changes in local upstream conditions that cause price and cost fluctuations in the supply chain. Other indirect impacts may occur, and each of these is material to corporate performance as a result of human rights risks or impacts.

One of the most powerful costs from implication with human rights risks or impacts related to business activities is the reputational cost.[191] This affects relationships with consumers or clients,[192] employees and recruits,[193] and investors and shareholders[194] who prefer to disassociate from operations that are complicit with adverse human rights outcomes.

If human rights risks and impacts are discovered by one actor in a particular sector, the ripple effect can re-define competitive advantage by changing public perception of the consequences of their consumer decisions.[195] This can radically alter the landscape for strategy to gain market share and consumer confidence and leave companies unprepared to show that they respect human rights risks at the back of the pack. As was witnessed with the growth of the fair trade coffee campaign, the major chain coffee shops faced pressure from consumers to carry fair trade coffee, reflecting their new understanding of the indirect costs of their purchasing decisions.[196] Some consumers were no longer satisfied with their previous criteria for coffee and instead chose to shop based on ethical supply chain practices of coffee merchants.

Finally, human rights risks in the supply chain can result in sudden changes to supply costs or prices for raw materials where conditions deteriorate or where regulation gets stronger to improve conditions. As conditions improve and regulations get stronger in countries where low labor standards keep supply chain costs low, the increase in costs will necessarily be passed up the supply chain and increase costs on the end-producer.[197] If conditions in supply chains change rapidly, for better or for worse, the resulting impact on manufacturing costs or raw materials prices may have a material impact on corporate performance.

III. Political Effects That Could Have a Material Impact on Business and Operations

Companies that are implicated in human rights abuses or violations may face greater scrutiny from government licensing agencies, and popular pressure could force the government to revoke or deny business licenses necessary to operate within the country.[198] This is a particular risk for major foreign multinational enterprises engaged in high-risk activities such as resource extraction, where public relations are strained by the nature of exporting natural resources from the land for a limited return to local populations.[199] Where society becomes passionately inflamed against a company that is complicit with human rights abuses, the government may have no choice but to follow the revocation of the social license to operate with a revocation or denial of the official business license to operate.[200] Alternative scenarios could include changes in government, resulting in the nationalization of particular industries or a rapid descent into civil conflict.[201]

C. Current Sources of Human Rights-Related Disclosure Regarding Public Companies

Business managers and accountants have voluntarily recognized the materiality of human rights-related information in some cases and have generally recognized the value of reporting social sustainability information informally as a public relations practice.[202] Auditing firms have directly recognized that human rights and other environmental, social and governance factors are material to investors and that businesses should investigate, assess, and disclose their risks and impacts where these are material to business performance.[203] Market analysts are gathering information on businesses' social and human rights records and risks,[204] and investment news services are providing analysis to the market in recognition of the materiality of these factors to decision-making.[205]

Voluntary disclosures by business and marketplace aggregation and publication of environmental, social, and governance factors show that this information is material to investment decision-making. The SEC considers the availability and current sources of disclosures in determining whether information is material. First, the SEC considers whether shareholders are demanding the information from public companies through the shareholder proxy proposal process. Second, it considers whether institutional investors or other groups are petitioning the SEC for interpretive advice for disclosing the information. Finally, it evaluates the existing public disclosures available through alternative sources.

I. Increasing Calls for Human Rights-Related Disclosure by Shareholders of Public Companies

Shareholder resolution proposal powers have been a primary tool to engage corporations in dialogue relating to human rights policies and practices for decades, and resolutions have frequently been advanced where dialogue has been unsuccessful. In 2013 alone, thirteen of the biggest corporations in America faced shareholder resolutions relating to human rights.[206] Many social-issue proposals brought by shareholders are withdrawn prior to the annual meeting because an agreement is reached with the company.[207] The majority of human rights proposals over the past four decades have been filed by institutional investors, such as the Interfaith Center on Corporate Responsibility (ICCR), the California Public Employees Retirement System,[208] or the New York State Common Retirement Fund.[209]

Shareholder proposals—and even just the potential to bring proposals—have been a useful tool for engaging corporations in dialogue to enhance their transparency regarding human rights issues, although few have achieved majority support as Boards routinely advocate voting against any social disclosure proposals.[210] The As You Sow Foundation has used shareholder advocacy to lead or participate in hundreds of shareholder dialogues and resolutions to impact policies and practices at companies, including Chevron, ExxonMobil, Dell, HP, PepsiCo, Starbucks, Target, Home Depot, and Walt Disney.[211] As You Sow generally operates by building coalitions with shareholder allies and engaging companies in proactive dialogue—resorting to active resolution proposals where dialogue alone is not enough to spur companies to action.[212] Other groups, such as Investors Against Genocide, advocate similar tactics for institutional investors to bring companies to align with their principles for responsible investment and have successfully promoted a shareholder resolution at ING Emerging Countries Fund to a wide 59.8% passing margin.[213] Additionally, shareholder activism by the New York State Comptroller has recently resulted in settlement agreements that require companies to disclose human rights risks and impacts related to their business activities.[214]

The New York State Comptroller also acts as trustee of the New York State Common Retirement Fund and has incorporated social and human rights considerations into investment decisions and long-term valuations in recent years.[215] Similar actions have been taken by institutional pension funds, such as the American Federation of State, County, and Municipal Employees (AFSCME) Pension Plan, which has sought to protect and enhance the economic value of its long-term investments by proposing heightened accountability and transparency by management to shareholders on issues including human rights risks arising out of companies' operations.[216] The U.S. Presbyterian Church also recently proposed that Caterpillar review and amend its human rights policies to conform more closely to international human rights and humanitarian standards.[217]

II. Petitions for Interpretive Advice Submitted to the SEC by Large Institutional Investors or Other Investor Groups

The SEC has only a few petitions on record that it has received from a large institutional or other investor group, demanding interpretive advice regarding disclosure relating to human rights matters.[218] However, this does not mean that investors are not interested in these issues. In fact, investor interest in human rights and other social impacts related to business activities has increased dramatically in recent years.

The socially responsible investment (SRI) industry has expanded in the United States, from controlling assets worth $639 billion in 1995 to $3.74 trillion in 2012.[219] This expansion is mirrored internationally by the wide acceptance of the UN PRIs, which now command assets of over $32 trillion—approximately 15% of the global market for securities—after launching in 2006 with signatories managing only $4 trillion in assets. SRI has grown to command significant market share and several large institutional investor groups, including pension funds and mutual funds. Even Goldman Sachs has developed its own fund based in sustainability metrics, known as GS Sustain.[220]

EIRIS Conflict Risk Network is a prime example of a coalition of almost 80 institutional investors, financial service providers, and other stakeholders calling upon corporate actors to fulfill their responsibility to respect human rights and to take steps that support peace and stability in areas affected by genocide and mass atrocities, such as Sudan and Burma.[221] The Network leverages the investment power of more than $6 trillion in assets under management in this mission to advocate for the corporate fulfillment of the responsibility to respect human rights in conflict environments, and coordinates groundbreaking research methods for the implementation of responsible investment policies relating to these challenging locations.[222] In May 2013, the Network became a part of EIRIS—a leading global provider of research into corporate environmental, social, and governance performance.[223]

This is reflected in other components of investment valuation, such as the change in metrics used to evaluate corporate market value. In 1975, tangible assets accounted for up to 80% of the valuation assessment for corporate securities' market value. In 2005, tangible assets accounted for only 20% of that valuation assessment, as intangible assets—including risk management, intellectual property, human and social capital—have come to be used to calculate 80% of the market valuation equation for corporations.[224]

III. Existing Public Disclosures Available Through Other Sources

Businesses, traditional financial accounting firms, and marketplace analyst research services have recognized that human rights-related matters are material to investors. Businesses have

demonstrated this through voluntary disclosures in securities reports and participation in social sustainability reporting systems or social auditing frameworks.[225] Over the past few years, financial accounting firms have expressed the materiality of human rights to investors in several reports from Deloitte, Ernst & Young, and others that have engaged in research collaborations with business schools and institutional investor groups.[226] Finally, market analysts and research companies have developed indices for measuring social impacts, including human rights risks and impacts, of business activities and offer these for investors who are seeking to apply the information in their decisions.

Voluntary Reporting in Periodic SEC Securities Disclosures

Many businesses are already voluntarily disclosing information regarding human rights-related matters,[227] and both accounting and law firms have published their acknowledgment that these matters are material to investors.[228] Certain companies, including Coca-Cola, have already begun to report human rights risks under their "Risk Factors" disclosures in item 1A of their annual Form 10-K securities reports to the SEC.[229] As companies proceed to identify, monitor, and address human rights risks and impacts in their activities, the acknowledged materiality of these matters by accounting firms may result in those firms and in-house corporate auditors deciding to report human rights-related matters when they pass the in-house materiality filter for significant relevance to investors and shareholders.

In their 2012 annual report, Coca-Cola specifically details concerns that negative publicity related to human rights, even if unwarranted, could damage their brand image and corporate reputation and cause the business to suffer.[230] This risk factor disclosure rests on Coke's recognition that their success "depends on our ability to maintain the brand image" and "maintain our corporate reputation."[231] Coke addresses their responsibility to respect human rights under the Guiding Principles and acknowledges that—based on their Human Rights Statement, including a Workplace Rights Policy and Supplier Guiding Principles—any allegations of a failure to respect internationally accepted human rights could have a significant impact on their corporate reputation.[232] They conclude that the reputational harm attached to any allegations of human rights violations, even if untrue, could significantly impact corporate reputation and long-term financial results.[233]

The analysis provided by Coca-Cola of the risks related to human rights violations, or even untrue allegations, to long-term financial results are consistent with the views emerging from accounting and auditing firms acknowledging that human rights issues are material to investors. Deloitte has proposed that environmental, social, and governance information, including information related to human rights matters, are material where disclosure informs an understanding of changes in company valuation.[234] They indicate that the materiality filter should capture these topics by considering how stakeholder actions related to reported

information regarding topics such as human rights risks and impacts—including boycott, activism, divestiture, seeking employment, or changing purchasing habits—yield potential impacts for company valuations within a relevant time frame.[235]

Ernst & Young, in collaboration with the Boston College Center for Corporate Citizenship, has also recently identified the benefits of corporate transparency for financial performance. Their research shows that informally reporting social sustainability performance has demonstrated direct benefits to the corporate balance sheet—a conclusion that implies information such as human rights risks and impacts are material to corporate performance.[236] The conclusions of both Deloitte and Ernst & Young's research shows that traditional accounting firms are finding that non-financial information, such as human rights risks and impacts, may be material to investors as they impact corporate performance financially or, in the alternative, lead to intangible advantages to reputation and image.[237]

Voluntary Informal Social Sustainability or Responsibility Reporting

There has been a proliferation of voluntary social sustainability reporting frameworks, and a significant majority of businesses are participating by voluntarily releasing informal corporate social responsibility or sustainability reports. The Global Reporting Initiative (GRI)[238] and the International Integrated Reporting Council (IIRC)[239] are the most popular frameworks, and the Sustainability Accounting Standards Board (SASB)[240] is also developing human rights and sector-specific disclosure standards to guide companies. Companies have subscribed to these standards in order to grant their reports a level of credibility, but most of the standards have still allowed companies considerable discretion in reporting details. These standards have made more information available, but the quality, comparability, and usefulness of the information varies across sectors and between businesses. Therefore, informal voluntary sustainability reports have been useful in making some information available to investors, but they have failed to allow investors to clearly understand, evaluate, and compare how different companies are identifying, reviewing, mitigating, and remedying human rights risks and abuses.[241]

The GRI was initiated in 1990 and the first reporting standard was announced in 2000, providing companies with a framework for reporting on sustainability topics. The standard has evolved over time, with the fourth "G4" guidelines released in May 2013.[242] The guidelines have been designed to harmonize with existing sustainability standards, including the OECD Guidelines for Multi-National Enterprises (MNEs), ISO 26000, and the UN Global Compact. In 2011-2012, more than 3900 companies participated in GRI certification training.[243]

Under the G4 Guidelines, companies may prepare a sustainability report "in accordance" with the standard by reporting only the "Core" elements or by preparing a "Comprehensive" report, including additional "Standard Disclosures" and more extensive performance analysis of

identified material "Aspects."[244] The determination of aspects of the GRI reporting standard that are material to the specific company is instrumental in determining what disclosures are made under the standard, since only aspects that are material to the company must be reported under the GRI standard.[245] Under the G4 guidelines, material aspects are those that: (1) "reflect the organization's significant economic, environmental, and social impacts" or (2) "substantively influence the assessments and decisions of stakeholders."[246]

The IIRC is an international standard for integrated corporate reporting that is currently piloting a program to result in communication by companies about how their "strategy, governance, performance and prospects lead to the creation of value over the short, medium, and long term."[247] The integrated reports are intended to target investors and decision-makers in capital markets by communicating the full range of factors that materially affect the issuer's ability to create value over time.[248] The IIRC envisions its standard as building on financial and other reporting to evolve corporate reporting to consider all aspects that interested stakeholders find relevant in capital allocation decisions.[249] These integrated reports will identify the factors that the organization believes are most important for their value creation over time and will provide additional details including financial statements and sustainability reports.[250] In that way, it complements and works with the GRI standards to incorporate sustainability reports alongside financial statements to reflect the integrated information that is material to investors.

The SASB is a standards organization that is developing sector-specific accounting standards related to material issues in those sectors for corporate reporting of non-financial information. SASB aims to provide relevant, useful, applicable, cost-effective, comparable, complete, directional, and auditable standards to improve the quality of corporate reporting for investors.[251] In developing their standards, they seek to support the convergence of international accounting standards and support the shift to integrated reporting of material sustainability issues in SEC reports such as the Form 10-K.[252] They are in the process of developing standards related to accounting and reporting human rights issues in order to continue towards meeting their vision where industry-specific standards enable companies to compete and improve performance on sustainability issues—such as respect for human rights—so that investors can capitalize the most sustainable companies.[253]

Marketplace Information Analysis and Investor Analytical Services

The marketplace has naturally organized to provide analytical services, information aggregation, and dedicated news categories to sustainability and human rights matters relating to business activities. Investor analytics and research database firms have been providing and refining indices and collections of information relating to environmental, social, and governance business practices, including human rights, for years. Investor-focused news services are dedicating web pages to reporting social impacts of business and sustainability issues.[254]

The MSCI risk and investment analytics firm produces indices for its clients related to environmental, social, and governance analysis and is related to socially-responsible investment criteria.[255] MSCI has consolidated many of the competing databases and indices under its umbrella with the KLD Research & Analytics, RiskMetrics, and Barra analytical methods offered to clients as part of their investment support tools.[256] These tools can be customized to meet particular investors' interests in analyzing performance related to specific categories, including human rights. Goldman Sachs has developed its own analytical approach to sustainability metrics, and incorporated it into a sustainable and principled investment fund.[257]

Bloomberg, the investment news provider, has a dedicated category for sustainability news, where human rights matters related to business activities are reported regularly.[258] Bloomberg has maintained a database that integrates sustainability into its market analytics since 2008 and has expanded its commitment to providing investors transparent information on these issues by offering a sustainability section in its news services since 2010.[259] However, the fact that this information is being provided by the information services marketplace does not mean that it is equally reliable, comparable, or useful to investors—SEC action to specifically require human rights disclosures could vastly improve the quality of information available to investors and stakeholders.[260]

The problem with these marketplace information and analytical resources for investors is that they are relying on incomplete, inconsistent, and sometimes incomparable information from companies. The data deficiency holds back the measurement of financial impacts from socially responsible corporate policies and processes and prevents investors from adequately incorporating this information into their decision-making process.[261] Although business, institutional investment funds, and marketplace information services providers have recognized that this information significantly alters the total mix of information available to investors, there is no standardized practice for delivering useful, objective data.[262]

The availability of current sources of human rights-related disclosure shows that businesses, accounting firms, civil society, news services, and other stakeholders expect investors to be interested in human rights for making capital allocation decisions. As shareholders and investors are demanding increasingly detailed and sophisticated disclosures related to human rights matters using shareholder resolutions, information providers are filling the gap in available information as best they can. Investors are demanding information by adhering to international standards of socially responsible investment principles and criteria. Businesses are voluntarily disclosing information by including it in existing items of their SEC formal reports or by informally providing public sustainability or corporate social responsibility reports. International standards for these sustainability reports have developed in order to guide companies to report material information in a clear, useful manner. Finally, marketplace information analysis providers, major investment and brokerage houses, and business news publications are including sustainability and human rights information prominently in their metrics and news services.

Unfortunately, this information is not consistent, comparable, or reliable across industries and even individual businesses—making it less useful to investors.[263]

Reporting Material Human Rights Information to the S.E.C.

Broad human rights disclosure allows shareholders to access comparable information about corporate activities and to more adequately assess risks to their portfolio companies.[264] This section outlines the two steps involved in implementing securities disclosure in the context of this type of broad human rights disclosure: (1) assessing business-related human rights risks and impacts through human rights due diligence and disclosure of such processes and (2) disclosing material human rights risks and impacts.

Under the second step of broad human rights disclosure, this section proposes two ways in which the SEC should act to require companies to disclose material human rights information under Regulation S-K. First, the SEC should issue interpretive guidance, clarifying the responsibilities of issuers to disclose material human rights risks, impacts, and due diligence processes and results under existing Regulation S-K reporting items. Second, the SEC should engage in a comprehensive rulemaking process to develop rules for disclosing human rights risks, impacts, and due diligence processes and results in a distinct reporting item. Engaging in either or both of these approaches will allow the SEC to enable investors to access key information that addresses management's integrity and a corporation's capacity to manage risks and create long-term, sustainable value through respect for human rights in business activities and relationships. Any clarification from the SEC, whether in the former of interpretive guidance or a new rule, should clearly extend disclosures to include the activities of a company's subsidiaries, contractors, and business partners, in line with the standards of the UN Guiding Principles and the OECD Guidelines for MNEs.[265]

A. Assessing Human Rights Risks and Impacts Related to Business Activities: Human Rights Due Diligence

The first step in securities disclosure always involves gathering, reviewing, and assessing information that fits within specifically required disclosure items. In this case, human rights risks and impacts related to business activities can arise from a variety of sources and may develop from supply chain or other business relationships, as well as directly in principal business operations. In order for issuers to effectively identify, review, mitigate, and report human rights risks and impacts related to their activities, they should conduct human rights due diligence.[266]

Generally, human rights due diligence should involve several steps to: (1) identify risks and impacts, (2) review and integrate findings, (3) track responses and mitigate potential impacts, (4) remedy any existing adverse impacts, and (5) communicate to stakeholders how impacts are addressed.[267] The UN Guiding Principles, in Principles 17-20, provide a flexible framework for

issuers to adapt based on their size, complexity, risk environment, and operational context.[268] By referencing these existing and developing standards, companies can provide clarity to investors while having the flexibility to adapt best practices (or not) as they emerge over time. Sector specific guides—like the OECD Due Diligence Guidance, which is geared towards supply chain due diligence in conflict-affected and high-risk areas—also provide a framework for human rights due diligence that could be used as an illustration by the SEC, while leaving the exact parameters of due diligences processes, if any, to issuers.[269]

B. Disclosing Material Human Rights Risks and Impacts

The second step for making securities disclosures is filtering and appropriately organizing the gathered information in material disclosures to allow investors and shareholders to understand corporate performance and prospects. The material information must be disclosed and organized in reports according to required disclosure items. In this case, material human rights information could be required to be disclosed based on: (1) existing securities regulation disclosure items or (2) the implementation of a new rule providing for a new item sub-heading for human rights-related risks and impacts.

I. Interpretive Guidance on Existing Securities Reporting Item Requirements for Human Rights-Related Matters

Material human rights risk and impacts should already be being disclosed by issuers under existing requirements in Regulation S-K, but the SEC should clarify these requirements using an interpretive guidance for human rights-related matters. Following the approach recently used to clarify reporting requirements for climate change matters and cyber-security information, the SEC should identify how issuers are required to disclose material human rights information under existing rules.[270] In particular, the description of business (Item 101), legal proceedings (Item 103), reporting of disclosure controls and procedures (Item 307), MD&A (Item 303), and risk factors (Item 503(c)) may already require disclosure of material human rights information.

Human rights risks and impacts are relevant to disclosures under item 101, the description of business, because they are a significant element of operating contexts where they exist. Further, any policies and processes in place to identify, assess, mitigate, and remedy human rights risks and impacts will be relevant to investors' understanding of an issuer's risks management strategies and capacities. These should be outlined and described in detail, and any known or potential risks should be disclosed in the description of business as part of the description of the plan of operation for the next period.

Legal proceedings related to human rights risks and impacts should be disclosed under item 103. The SEC should clarify that legal proceedings involving allegations of human rights abuses or violations are not "ordinary routine litigation incidental to the business" and thus are material to investors. As has been suggested by Coca-Cola and stakeholder research, even untrue allegations of human rights violations can have a material impact on corporate reputation and long-term value.[271] Similar to legal proceedings related to climate change, there is sufficient evidence to support disclosure of legal proceedings implicating a corporation or any subsidiary or business segment in human rights violations at a lower standard of materiality than is generally required for item 103 disclosures.[272]

Further, as management is required to provide a narrative perspective of business performance, including trends, uncertainties, and future prospects, there should be some discussion of human rights risks and impacts in the MD&A under item 303. Any known or uncertain trends relating to human rights risks and impacts should be described and management should provide a narrative explanation of how the issuer is prepared to identify, prevent, and mitigate potential or existing occurrences.

Human rights due diligence policies and procedures should be disclosed as part of the item 307 reporting of disclosure controls and procedures.[273] These reports should include: (1) the concrete steps taken to identify risks to human rights; (2) the results of the company's inquiry, including risks and impacts identified; and (3) steps actually taken to mitigate the risks and prevent human rights abuses. This would require senior management to assess and take responsibility for the effectiveness of these internal controls and procedures and vouch for the resulting human rights disclosures.

The direct and indirect effects to securities valuations, corporate reputation, and competitive advantage related to human rights risks and impacts should result in material disclosures under item 503(c) as risk factors for corporate performance. Coca-Cola has led the way with their recognition that the potential for damage to their reputation and resulting stakeholder actions could significantly affect their bottom line.[274] It is clear from the consistent findings of research on the impact of sustainability reporting that social responsibility issues, including human rights, are important sources of risk and potential value.[275] The SEC should clarify that issuers need to be assessing their human rights risks and impacts to identify risk factors for disclosure under item 503(c) that could affect corporate performance.

II. The Development of a New Rule for Human Rights Reporting

The SEC may engage in rulemaking related to required disclosures where it is mandated by Congress under existing securities laws (such as the Exchange Act or Dodd-Frank Act[276]), according to a fresh congressional mandate, or following rule-making petitions proposed by the

public.[277] According to Section 14(a) of the Securities Act, Congress has delegated broad authority to the SEC to engage in rulemaking relating to proxy solicitations "as necessary or appropriate in the public interest, or for the protection of investors."[278] As this paper has documented, human rights risks and impacts are a matter of domestic and global public interest, and are relevant to corporate performance and the protection of investors. Interested stakeholders should petition the SEC to promulgate a new mandatory disclosure rule related to human rights in periodic disclosures, including through annual proxy disclosures and through updates in periodic disclosures regarding material changes.

In developing a new rule, the SEC should consider how to incorporate disclosures of human rights-related matters in order to provide clear, consistent, and comparable information between issuers. Certain sectors will, due to the nature and context of their operations, be more prone to risks and impacts related to human rights. Disclosure of their policies and processes for identifying, tracking, mitigating, and remedying those risks and impacts are materially relevant to investors' understanding of management's integrity, and capability to manage risks.

A new rule—and the rulemaking process—could investigate the value of consolidating human rights risk and impact disclosures under one item heading or sub-heading. This "Human Rights Due Diligence" section would provide transparent and accountable disclosure of all material information and allow stakeholders to engage the corporation to improve or assist with issues related to human rights. Finally, this rule could be used to meet part of the U.S. government's duty to protect human rights-related to business activities, under the UN Guiding Principles, which it has already endorsed. This would require, at minimum, that the rule include a disclosure of the issuer's human rights policies and details of the human rights due diligence process and results.

Conclusion

Heightened interest from the public, policy-makers, academics, investors, and businesses indicate that information relating to human rights matters is in fact material to investor decision-making. Domestic and international legislative and policy action have built—and continue to build—a global consensus around the need to tackle the adverse social and human rights impacts of globalized business activities. Investors are increasingly demanding corporate transparency through shareholder resolutions and endorsement of responsible investment principles. In turn, businesses are recognizing the importance of their performance relating to social responsibility issues and are publishing both formal and informal reports to gain positive publicity and investor support for their efforts in meeting these changing global standards. At the same time, marketplace information analysts and investor support service providers are gathering and integrating available information into useful analyses for investors' capital allocation decisions.

The UN Guiding Principles provide a set of foundational benchmarks for building human rights considerations into internal auditing and risk mitigation processes through human rights due diligence and reporting. Since the United States government has endorsed the Guiding Principles, it should examine implementation of these Principles through its own existing laws and regulations. Furthermore, the OECD Guidelines for MNEs and ISO 26000 have entrenched and expanded upon the Guiding Principles to formulate best practices standards for corporations around the world to tackle the challenges of business impacts relating to human rights. These systems have developed as legislators, civil society, and businesses have converged on a common understanding of the responsibility for businesses to respect human rights. The implementation of the responsibility to respect human rights demands that corporations conduct human rights due diligence to investigate their operations for adverse human rights risks and impacts and communicate those findings to stakeholders and the public.

In order to promote orderly, efficient capital markets and protect investors from misleading or inaccurate information that affects the value of the securities on the market (such as in stand-alone social reports), the SEC should act to require issuers to disclose their human rights due diligence processes and findings regarding risks and impacts related to their business activities. Under existing securities regulations, issuers may have an obligation to disclose human rights risks and impacts related to their operations, and the SEC should provide interpretive guidance clarifying those items where material human rights issues should be reported. Based on the heightened interest from the public, legislators, the international community, and voluntary business disclosures, the SEC should provide interpretive guidance and engage in a comprehensive rulemaking process to establish clear, consistent, and comparable disclosure requirements that will allow investors to effectively consider the human rights risks and impacts connected to investment in certain companies. This information is highly important as it significantly alters the total mix of available information to investors. It should therefore be provided in a manner that adequately allows investors to usefully decide how to allocate their resources.

Endnotes

[1] The United States does have several statutes that apply certain laws and standards to U.S. companies in their activities abroad. These include the Foreign Corrupt Practices Act, Pub. L. 95-213 (1977), the Torture Victim Protection Act, Pub. L. 102-256 (1991), and the Trafficking Victims Protection Reauthorization Act, H.R. 7311 (2008). The Alien Tort Claims Act, 28 U.S.C. § 1350 (2013) has been used in recent decades to hold companies liable for violations of the law of nations committed abroad.

[2] Many human rights violations resulting from business activities occur in challenging political environments, where conflict or other high-risk factors have limited the capacity or willingness of the State to effectively establish the rule of law or to operate a functioning judiciary.

[3] Profits are at an all-time high for the world's largest, most powerful corporations. *See* Henry Blodget, *Corporate Profits Just Hit an All-Time High, Wages Just Hit an All-Time Low*, BUS. INSIDER (June 22, 2013), http://www.businessinsider.com/corporate-profits-just-hit-an-all-time-high-wages-just-hit-an-all-time-low-2012-6. The example of the lack of enforcement for clear violations of law and regulation by financial institutions in the "too big to fail" category highlights this phenomenon in the context of the 2008/09 financial system collapse. *See, e.g.*, Peter Schroeder, *Holder: Big Banks' Size Complicates Prosecution Efforts*, HILL (June 3, 2013), http://thehill.com/blogs/on-the-money/banking-financial-institutions/286583-holder-big-banks-size-complicates-prosecution-efforts.

[4] *E.g.*, Andrew North, *Dhaka Rana Plaza Collapse: Pressure Tells on Retailers and Government*, BBC NEWS ASIA (May 14, 2013), http://www.bbc.co.uk/news/world-asia-22525431; *Bangladesh Accord on Fired and Building Safety released*, IndustriALL Global Union (May 15, 2013), http://www.industriall-union.org/bangladesh-accord-on-fire-and-building-safety-released.

[5] *E.g.*, United Nations, *Principles for Responsible Investment*, http://www.unpri.org/ (last visited July 18, 2013).

[6] Human Rights Council, *Report of the Special Representative to the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprises, John Ruggie: Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework*, U.N. Doc. A/URC/17/31 (Mar. 21, 2011), *available at* http://www.business-humanrights.org/media/documents/ruggie/ruggie-guiding-principles-21-mar-2011.pdf [hereinafter Guiding Principles].

[7] Chris Power & Arun Devnath, *Bangladesh's Tazreen Fire is Followed by Further Garment Factory Blazes*, BLOOMBERG BUS. WEEK (Dec. 27, 2012), http://www.businessweek.com/articles/2012-12-27/after-the-tazreen-fire-in-bangladesh-more-fires-in-garment-factories; Declan Walsh & Steven Greenhouse, *The Human Price: Certified Safe, a Factory in Karachi Still Quickly Burned*, N.Y. TIMES (Dec. 7, 2012), http://www.nytimes.com/2012/12/08/world/asia/pakistan-factory-fire-shows-flaws-in-monitoring.html?pagewanted=all.

[8] Julfikar Ali Manik & Jim Yardley, *Building Collapse in Bangladesh Leaves Scores Dead*, N.Y. TIMES (Apr. 24, 2013), http://www.nytimes.com/2013/04/25/world/asia/bangladesh-building-collapse.html?smid=fb-nytimes&WT.z_sma=WO_BBC_20130424&_r=0; *Disaster in Bangladesh: Rags in the Ruins*, ECONOMIST (May 4, 2013), http://www.economist.com/news/asia/21577124-tragedy-shows-need-radical-improvement-building-standards-rags-ruins; Dan Viederman, *Supply Chains and Forced Labour After Rana Plaza: Lessons Learned*, GUARDIAN (May 30, 2013), http://www.guardian.co.uk/global-development-professionals-network/2013/may/30/rana-plaza-bangladesh-forced-labour-supply-chains.

[9] *See* Rebecca Greenfield, *Apple is Breaking Up with Foxconn for a New iPhone Builder with Labor Problems*, ATLANTIC WIRE (May 29, 2013), http://www.theatlanticwire.com/technology/2013/05/apples-foxconn-pegatron/65706/; Christina Bonnington, *Probe Finds 'Serious and Pressing' Violations at Foxconn Plants*, WIRED.COM: GADGET LAB (May 29, 2012), http://www.wired.com/gadgetlab/2012/03/apple-foxconn-audits/.

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[12] *E.g.*, *Pinera Blasts Environmental Licensing for Giant Pascua-Lama Gold Mine Project*, MERCOPRESS (June 8, 2013), http://en.mercopress.com/2013/06/08/pinera-blasts-environmental-licensing-for-giant-pascua-lama-gold-mine-project; Julie Gordon, *Barrick Gold to Submit Water Plan for Pascua Lama to Chile Authorities Soon*, GLOBE & MAIL (June 5, 2013), http://www.theglobeandmail.com/report-on-business/international-business/latin-american-business/barrick-gold-to-submit-water-plan-for-pascua-lama-to-chile-authorities-soon/article12360914/; Alexandra Ulmer & Fabian Cambero, *Barrick's Pascua-Lama Gold Project Frozen for at Least 1-2 Years: Chile Regulator*, REUTERS (May 30, 2013), http://www.reuters.com/article/2013/05/31/us-chile-pascualama-regulator-idUSBRE94T14X20130531.
[13] *E.g.*, CONE COMMUNICATIONS/ECHO, 2013 GLOBAL CSR SURVEY 25, *available at* http://www.conecomm.com/2013-global-csr-study-report (last visited July 18, 2013) (citing results that 55% of respondents have boycotted and refused to purchase products from companies they know to have behaved irresponsibly); Jayne O'Donnell, *Survey: Most Would Boycott Irresponsible Company*, USA TODAY (May 21, 2013), http://www.usatoday.com/story/money/business/2013/05/21/consumers-boycott-companies-bad-behavior-gap-protests/2343619/; *Boycotts List*, ETHICAL CONSUMER (Mar. 25, 2013), http://www.ethicalconsumer.org/boycotts/boycottslist.aspx.
[14] *See* RAINFOREST ALLIANCE, http://www.rainforest-alliance.org/ (last visited July 24, 2013) (certifying products as responsibly mitigating their impact on the rainforest).
[15] *E.g.*, FAIR TRADE USA, http://www.fairtradeusa.org/ (last visited July 24, 2013) (assuring consumers "that the farmers and workers behind the product got a better deal . . . [and] that their purchases are socially and environmentally responsible").
[16] U.S. SOCIAL INVESTMENT FORUM FOUNDATION, EXECUTIVE SUMMARY: REPORT ON SUSTAINABLE AND RESPONSIBLE INVESTING TRENDS IN THE UNITED STATES (2012) at 11, *available at* http://www.ussif.org/files/Publications/12_Trends_Exec_Summary.pdf.
[17] *See PRI Fact Sheet*, UN Principles for Responsible Investment (May 2013), http://www.unpri.org/news/pri-fact-sheet/ (last visited July 18, 2013).
[18] *See* Margaret Levi & April Linton, *Fair Trade: A Cup at a Time?*, 31 POL. & SOC'Y 407, 424 (2003) (highlighting the success of activists who, in the early 1990s, challenged Starbucks to stop buying from plantatiations where workers were not paid fair wages); DOUGLAS HOLT & DOUGLAS CAMERON, CULTURAL STRATEGY: USING INNOVATIVE IDEOLOGIES TO BUILD BREAKTHROUGH BRANDS 104-05 (2010) (citing the pressure exerted on Starbucks by Transfair USA before Starbuck's decision to purchase a small percentage of fair trade coffee, to which customers responded positively); Colleen Haight, *The Problem with Fair Trade Coffee*, 9 STAN. SOC. INNOVATION REV. 74, 77 (2011) (discussing Whole Foods Market's evolution from initially rejecting the fair trade model based on concern over the quality of fair trade coffee to more recently purchasing fair trade coffee due to customers' demands).
[19] Conflict Risk Network, *CRN Letter to the Burman Human Rights Officer on Title of Information Collection: Reporting Requirements on Responsible Investment in Burma* (Oct. 4, 2012), *available at* http://crn.eiris.org/files/Burma%20Reporting%20Requirements%20-%20Investor%20Comment_4%20Oct%202012.pdf.
[20] *See* Cynthia Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1211-35 (1999) (discussing the brain trust relied upon by President Roosevelt and the legislative drafters in forming the SEC, its purposes, philosophical foundation, and design).
[21] U.S. Securities & Exchange Comm'n, *Rulmaking: How It Works*, http://www.sec.gov/answers/rulemaking.htm (last visited July 26, 2013) [hereinafter *Rulemaking: How It Works*].

[22] *See* Securities Act of 1933, Pub. L. 112-106 (2012); Securities Exchange Act of 1934, Pub. L. 112-158 (2012).
[23] *See id.*; Trust Indenture Act of 1939, Pub. L. 111-229 (2010); Investment Company Act of 1940, Pub. L. 112-90 (2012); Investment Advisers Act of 1940, Pub. L. 112-90 (2012).
[24] Sarbanes Oxley Act of 2002, 116 Stat. 745 (2002).
[25] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 §§1502-04, 15 U.S.C. §78a et seq. (2013) [hereinafter Dodd-Frank Act].
[26] *See* Steven J. Markovich, *The Dodd-Frank Act*, COUNSEL ON FOREIGN RELATIONS (July 23, 2012), http://www.cfr.org/united-states/dodd-frank-act/p28735; Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817 (2007), *available at* http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1136&context=facpub; Allison Fass, *One Year Later: The Impact of Sarbanes-Oxley*, FORBES.COM (July 22, 2003), http://www.forbes.com/2003/07/22/cz_af_0722sarbanes.html.
[27] *See* Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 764-65 (1995).
[28] *See* Williams, *supra* note 20, at 1211-35 (discussing the writings of Louis D. Brandeis, Adolf A. Berle, and Gardiner C. Means that champion disclosure as a regulatory method "to bring to bear public pressure to change the actions and attitudes of corporate managers, bankers, and other insiders" and their roles in influencing President Roosevelt, as well as Representative Rayburn and Senator Fletcher, the key drafters of the Securities Act (1933) and the Securities and Exchange Act (1934)).
[29] *See id.* at 1228.
[30] *See id.* at 1234 (discussing the House Committee Reports and introductory statements of Representative Rayburn and the general tone of the debate—which was overwhelmingly positive, with the only criticism being that the bill perhaps did not go far enough to regulate corporate conduct—and attesting to the belief of legislators that they had a right to demand that the people who run businesses operate according to clean, fair, and honorable standards) (citing the statement of Rep. Rayburn of the House Commerce Committee, 77 Cong. Rec. 2910-55, 2919 (1933)); *id.* at 1241 (citing the statement of Sen. Fletcher, 78 Cong. Rec. 8161 (1934)), where he re-introduced the second draft of the Securities and Exchange Act of 1934, where he identified the "cardinal principles [he] conceived to be, first, restoring as a rule of moral and economic conduct, a sense of fiduciary obligation; and, second, establishing social responsibility, as distinguished from individual gain, as the goal").
[31] Securities Exchange Act of 1934, *supra* note 22, §§12-15.
[32] 17 C.F.R. § 229 (2012); *see* Securities Exchange Act of 1934, *supra* note 22, §§12-15.
[33] *See* 17 C.F.R. § 240.14a-1 (2012).
[34] 17 C.F.R. § 230.408 (2012).
[35] 17 C.F.R. § 240.10b-5 (2012); 15 U.S.C. § 78j (2013).
[36] *See* 17 C.F.R. § 229 (2012).
[37] *See* SIMON ZADEK & MIRA MERME, ACCOUNTABILITY, REDEFINING MATERIALITY: PRACTICE AND PUBLIC POLICY FOR EFFECTIVE CORPORATE REPORTING, 12-13 (July 2003), *available at* http://www.accountability.org/images/content/0/8/085/Redefining%20Materiality%20-%20Full%20Report.pdf.
[38] *See* 17 C.F.R. § 229 (2012); 17 C.F.R. § 230.408 (2012).
[39] *See* Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976).
[40] 17 C.F.R. § 229 (2012).
[41] U.S. SECURITIES & EXCHANGE COMM'N, FORM 10-Q, OMB NO. 3235-0070, *available at* http://www.sec.gov/about/forms/form10-q.pdf; U.S. SECURITIES & EXCHANGE COMM'N, FORM 10-K, OMB NO. 3235-0063, *available at* http://www.sec.gov/about/forms/form10-k.pdf. Foreign private issuers must file an annual report using Form 20-F, which requires essentially the same information. *See* U.S.

SECURITIES & EXCHANGE COMM'N, FORM 20-F, OMB NO. 3235-0288, *available at* http://www.sec.gov/about/forms/form20-f.pdf.

[42] 17 C.F.R. § 229 (2012).

[43] *E.g.*, U.S. SECURITIES & EXCHANGE COMM'N, COMPLIANCE AND DISCLOSURE INTERPRETATIONS: REGULATION S-K (2013), *available at* www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm; U.S. SECURITIES & EXCHANGE COMM'N, INTERPRETATION: COMMISSION GUIDANCE REGARDING MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, SECURITIES ACT, RELEASE NO. 33-8350 (Dec. 19, 2003), *available at* http://www.sec.gov/rules/interp/33-8350.htm [hereinafter Securities & Exchange Comm'n, Release No. 33-8350].

[44] 17 C.F.R. § 229.101 (2012).

[45] 17 C.F.R. § 229.101(a)(2)(iii)(B) (2012).

[46] 17 C.F.R. § 229.101 (2012).

[47] 17 C.F.R. § 229.101(c) (2012).

[48] 17 C.F.R. § 229.101(c)(x) (2012).

[49] 17 C.F.R. § 229.101(c)(xii) (2012).

[50] *See* 17 C.F.R. § 229.103 (2012).

[51] *See* 17 C.F.R. § 229.103 (2012); 17 C.F.R. § 229.103, Instr. 2 (2012).

[52] *See* 17 C.F.R. § 229.103, Instr. 2 (2012).

[53] 17 C.F.R. § 229.103, Instr. 5 (2012).

[54] 17 C.F.R. § 229.103, Instr. 5 (2012).

[55] *See* U.S. SECURITIES & EXCHANGE COMM'N, INTERPRETATION: COMMISSION GUIDANCE REGARDING MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS; CERTAIN INVESTMENT COMPANY DISCLOSURES, RELEASE NO. 33-6835 (May 18, 1989), *available at* http://www.sec.gov/rules/interp/33-6835.htm.

[56] *See* Securities & Exchange Comm'n, Release No. 33-8350 (Dec. 19, 2003), *supra* note 43.

[57] 17 C.F.R. § 229.303a, Instr. 5 (2012).

[58] *See generally, id*.

[59] *See* Securities & Exchange Comm'n, Release No. 33-6835 (May 18, 1989); Securities & Exchange Comm'n, Release No. 33-8350 (Dec. 19, 2003), *supra* note 43; *see also* John D. Moore, *SEC Calls for a Clearer View From Management*, 23 INT'L FIN. L. REV. 25, 26-7 (2004).

[60] 17 C.F.R. § 229.307 (2012).

[61] 17 C.F.R. § 229.503 (2012).

[62] *See, e.g.*, DEERE & CO., ANNUAL REPORT (FORM 10-K), at 11-16 (2012), *available at* http://www.deere.com/en_US/docs/Corporate/investor_relations/pdf/financialdata/reports/2013/10kreport2012.pdf.

[63] 17 C.F.R. § 229.503(c) (2012).

[64] *Id*.

[65] *Id*.

[66] *Id*.

[67] 17 C.F.R. § 240.14a-8 (2013).

[68] *Id*.

[69] *See* 17 C.F.R. § 240.14a-8(f)-(i) (2013) (identifying the reasons why an issuer may be permitted to exclude a proxy disclosure request, including: eligibility or procedural deficiencies, impropriety under state law, violation of law, violation of proxy rules, personal grievance or special interest, irrelevance (measured by the proxy request relating to something that accounts for less than 5% of the companies' total assets at the end of the last fiscal year), absence of power/authority, overriding management functions, director elections, conflict with company's proposal, substantial implementation having been achieved already, duplication of request, resubmission of significantly unpopular proposal over time, or relation to a specific amount of dividends.); David M. Lynn, *The Dodd-Frank Act's Specialized*

Corporate Disclosure: Using the Securities Laws to Address Public Policy Issues, 6 J. BUS. & TECH. L. 327 (2011), *available at* http://digitalcommons.law.umaryland.edu/jbtl/vol6/iss2/3.
[70] *See* Exchange Act §14(a); 15 U.S.C. §78n (2013).
[71] *See generally*, Williams, *supra* note 20.
[72] *See* 17 C.F.R. §230.408 (2012); 17 C.F.R. §240.12b-20 (2012).
[73] *See* 17 C.F.R. §240.12b-20 (2013).
[74] *See* 17 C.F.R. §240.10b-5 (2013).
[75] 17 C.F.R. §240.10b-5(b) (2013); 15 U.S.C. 78j (2013).
[76] *See* Rachel Cherington, *Securities Laws and Corporate Social Responsibility: Toward An Expanded Use of Rule 10b-5*, 25 U. PA. J. INT'L. ECON. L. 1439, 1449 (2004).
[77] *See id*. at 1449-50.
[78] *See id*. at 1451 (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968)). For omission cases, *see* Affiliated Ute Citizens of Utah v. U.S., 406 U.S. 128, 153-54 (1972). For misstatement and fraud-on-the market cases, *see* Basic Inc. v. Levinson, 485 U.S. at 246-47.
[79] *See* American Petroleum Institute et al. v. Securities & Exchange Comm'n et al., Civil Action No. 12-1668 (JDB) (D.C. Dist. 2013) (noting how the judge identified that there are exceptions under 78m, n, etc., where the SEC may make exemptions for requiring all disclosures made to the agency be public and identifying the bases for that); *see also* Basic Inc., 485 U.S. at 231-32 (highlighting the Court's "materiality requirement" requiring the disclosure of the seemingly immaterial fact if there was a substantial likelihood that the omitted fact would have been viered by the reasonable invester as having significantly altered the totality of all information made available).
[80] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (cited in Basic, Inc., 485 U.S. at 234.).
[81] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976).
[82] *Id*.
[83] *Id*. at 449 (defining the "total mix" standard of materiality in the context of a controversy relating to proxy statement disclosure under section 14a-9 of securities law); *see also* Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (adopting the *TSC Industries* "total mix" standard of materiality for the section 10(b) and Rule 10(b)5 context of securities law).
[84] TSC Industries, Inc., 426 U.S. at 450; *see also* Basic, Inc., 485 U.S. at 236.
[85] Basic, Inc., 485 U.S. at 238.
[86] *Id*. at 238 (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d at 849 (2d Cir. 1968)).
[87] *Id*. at 236 (citing TSC Industries, Inc., 426 U.S. at 450).
[88] SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45 (1999).
[89] *Id*.
[90] *Id*.
[91] *See* Basic, Inc., 485 U.S. at 231-32; TSC Industries, Inc., 426 U.S. at 449-50.
[92] *See id*; *see also* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L. Q. 417 (2003).
[93] *See* Basic, Inc., 485 U.S. at 231-32; TSC Industries, Inc., 426 U.S. at 448-49.
[94] *See* Lucian A. Bebchuck & Robert J. Jackson, Jr., *Shining Light on Corporate Political Spending*, Discussion Paper No. 728, *prepared for publication in* 101 GEO. L.J. 923, 928-29 (2013); *see also* TSC Industries, Inc., 426 U.S. at 449.
[95] Securities & Exchange Comm'n, Commission Guidance Regarding Disclosure Related to Climate Change (Jan. 27, 2010), Release Nos. 33-9106; 34-61469; FR-82, *available at* http://www.sec.gov/rules/interp/2010/33-9106.pdf [hereinafter Climate Change Guidance (2010)].
[96] *See id*. at 1-2.
[97] *See id*. at 3-7.

[98] *E.g.*, Dodd-Frank Act, *supra* note 25; California Transparency in Supply Chains Act, S.B. No. 657 (2010), *available at* http://www.state.gov/documents/organization/164934.pdf; Maryland H.B. 425, Procurement – Required Disclosure – Conflict Minerals Originated in the Democratic Republic of the Congo (May 2, 2012), *available at* http://www.srz.com/files/upload/Conflict_Minerals_Resource_Center/Text_of_Maryland_House_Bill_425_on_Conflict_Minerals.pdf [hereinafter Maryland Conflict Minerals Bill].

[99] Human Rights Council, *Protect, Respect and Remedy: A Framework for Business and Human Rights, Report of the Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprises, John Ruggie*, U.N. Doc. A/HRC/8/5 (Apr. 7, 2008), *available at* http://www.reports-and-materials.org/Ruggie-report-7-Apr-2008.pdf [hereinafter PRR Framework].

[100] Guiding Principles, *supra* note 6.

[101] International Corporate Accountability Roundtable, *ICAR Coalition Letter to President Obama on Implementation of the UN Guiding Principles* (July 24, 2013), *available at* http://accountabilityroundtable.org/analysis/icar-coalition-letter-to-president-obama-on-implementation-of-the-un-guiding-principles/.

[102] *E.g.*, EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE (EITI), http://eiti.org (last visited July 25, 2013); GLOBAL NETWORK INITIATIVE (GNI), http://globalnetworkinitiative.org (last visited July 25, 2013); ELECTRONIC INDUSTRY CITIZENSHIP COALITION (EICC), http://www.eicc.info (last visited July 25, 2013); RESPONSIBLE JEWELLERY COUNCIL (RJC), http://www.responsiblejewellery.com (last visited July 25, 2013); CONFLICT-FREE SMELTER INITIATIVE (CFSI), http://www.conflictfreesmelter.org (last visited July 25, 2013); VOLUNTARY PRINCIPLES ON SECURITY AND HUMAN RIGHTS, http://www.voluntaryprinciples.org (last visited July 25, 2013) [hereinafter VOLUNTARY PRINCIPLES].

[103] Dodd-Frank Act, *supra* note 25, §§1502-04; 15 U.S.C. §78(a), et seq. (2013).

[104] *See* Climate Change Guidance (2010), *supra* note 95.

[105] SECURITIES & EXCHANGE COMM'N, DIVISION OF CORPORATE FINANCE, CF DISCLOSURE GUIDANCE: TOPIC NO. 2 CYBERSECURITY (2011), *available at* http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm [hereinafter Cyber-Security Guidance].

[106] U.S. DEPT. OF STATE, RESPONSIBLE INVESTMENT IN BURMA REPORTING REQUIREMENTS, OMB NO. 1405-0209, *ailable at* http://www.humanrights.gov/wp-content/uploads/2013/05/Responsible-Investment-Reporting-Requirements-Final.pdf.

[107] Dodd-Frank Act, *supra* note 25, §1503; 17 C.F.R. §§229.104, 239, 249 (2013).

[108] Dodd-Frank Act, *supra* note 25, §1504; 17 U.S.C. §78m(q) (2013).

[109] Dodd-Frank Act, *supra* note 25, §1502; 15 U.S.C. §78m(p) (2013).

[110] *See* Dodd-Frank Act, *supra* note 25, §§1502-04; 15 U.S.C. §78(a), et seq. (2013); Lynn, *supra* note 69, at 330 (discussing the intent of Congress to advance the purposes identified).

[111] *See* Lynn, *supra* note 69, at 330.

[112] *See Reinforcing the Investor Case: Conflict Minerals and Revenue Transparency*, CALVERT INVESTMENTS (Feb. 21, 2012), http://www.calvert.com/newsArticle.html?article=19119; Boston Common Asset Management et al., *Comment on Rulemaking Related to Dodd-Frank Act Conflict Minerals Section 1502* (Feb. 1, 2012), *available at* http://www.sec.gov/comments/s7-40-10/s74010-475.pdf.

[113] 17 C.F.R. §240, §249b (2012); Conflict Minerals, Exchange Act Release No. 34-67716 (Aug. 22, 2012), *available at* http://www.sec.gov/rules/final/2012/34-67716.pdf; *see also* OECD PUBLISHING, OECD DUE DILIGENCE GUIDANCE FOR RESPONSIBLE SUPPLY CHAINS FROM CONFLICT-AFFECTED AND HIGH RISK AREAS (2011) [hereinafter OECD Due Diligence Guidance].

[114] Dodd-Frank Act, *supra* note 25, at §1502; 15 U.S.C. §78m(p)(1)(A)(i) (2013) (requiring companies to conduct supply chain due diligence in accordance with the standards to be established by the Comptroller of the United States and the rules promulgated by the SEC in consultation with the Secretary of State).
[115] Dodd-Frank Act, *supra* note 25, at §1503; 17 C.F.R. §§229.104, 239, 249 (2013).
[116] Securities & Exchange Comm'n, Mine Safety Disclosure, Securities Act Release No. 9,164, Exchange Act Release No. 63,548, 75 Fed. Reg. 245, 80,374 (proposed Dec. 22, 2010); Mine Safety Disclosure, 17 C.F.R. §§229.104, 239, 249; Federal Mine Safety and Health Act (1977); 30 U.S.C. §801 *et seq*. (2012).
[117] *See* Mine Safety Disclosure, 17 C.F.R. §229.104 (2012); Securities & Exchange Comm'n (Form 8-K), Current Report, *available at* http://www.sec.gov/about/forms/form8-k.pdf.
[118] Dodd-Frank Act, *supra* note 25, §1503; 15 C.F.R. §229.104, 239, 249 (2013).
[119] Dodd-Frank Act, *supra* note 25, §1504(q)(2)(A); 17 U.S.C. §78m(q) (2013); Securities & Exchange Comm'n, Disclosure of Payments by Resource Extraction Issuers, Release No. 34-67717 (Nov. 13, 2012), *available at* http://www.sec.gov/rules/final/2012/34-67717.pdf.
[120] *Id*.
[121] *See id*.; EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE (EITI) FACT SHEET, http://eiti.org/files/EITI-fact-sheet-English.pdf (last visited July 25, 2013).
[122] *See, e.g*., Lynn, *supra* note 69, at 337.
[123] *See id*.
[124] *See* Galit A. Sarfaty, *Human Rights Meets Securities Regulation*, 53 VA. J. INT'L L. (forthcoming 2013).
[125] *See* Williams, *supra* note 20, at 1234, 1241 (citing legislative history of House and Senate debates, as well as the intellectual foundation of the securities regulation system in the United States as based in theories that transparency will motivate fair and honest conduct in corporate behavior and encourage social responsibility by requiring public disclosures).
[126] *See* Dodd-Frank Act, *supra* note 25; 15 U.S.C. §78(a) *et seq*. (2013); Lynn, *supra* note 69, at 337.
[127] *Calvert Awaits Dodd-Frank Rules on Conflict Minerals and Extractive Revenue Payments*, CALVERT INVESTMENTS (Aug. 21, 2012), http://www.calvert.com/newsArticle.html?article=19803; *Materiality of Disclosure Required by the Energy Security Through Transparency Act*, CALVERT INVESTMENTS (Apr. 2010), http://www.calvert.com/NRC/literature/documents/10003.pdf.
[128] Climate Change Guidance, *supra* note 95; Cyber-Security Guidance, *supra* note 105.
[129] *See* Climate Change Guidance, *supra* note 95, at 12-20; Cyber-Security Guidance, *supra* note 105, at 2-6.
[130] *See* Climate Change Guidance, *supra* note 95, at 10.
[131] *See* Cyber-Security Guidance, *supra* note 105, at 2-5.
[132] U.S. DEPT. OF STATE, *supra* note 106.
[133] *Id*.
[134] *Id*.
[135] *Id*.
[136] *See* 15 U.S.C. § 78dd (2012).
[137] *See Foreign Corrupt Practices Act: An Overview*, U.S. DEPT. OF JUSTICE, http://www.justice.gov/criminal/fraud/fcpa/ (last visited June 24, 2013).
[138] *See Spotlight on Foreign Corrupt Practices Act*, SECURITIES & EXCHANGE COMM'N, http://www.sec.gov/spotlight/fcpa.shtml (last visited June 24, 2013).
[139] *See id*.; *Foreign Corrupt Practices Act: An Overview*, *supra* note 137.
[140] California S.B. No. 861 (2011), *available at* http://accountabilityroundtable.org/wp-content/uploads/2011/10/sb_861_bill_20111009_chaptered.pdf; *see* Corrine Hauth, *Gov. Brown Signs California's Conflict Minerals Bill,* ENOUGH PROJECT (Oct. 14, 2011), http://www.enoughproject.org/blogs/gov-brown-signs-ca-conflict-minerals-bill; *see also*, *Conflict Minerals Provision of Dodd-Frank*, KPMG LLP (June 1, 2012),

http://www.kpmginstitutes.com/government-institute/insights/2012/conflict-minerals-provision-dodd-frank.aspx.

[141] *See* Maryland Conflict Minerals Bill, *supra* note 98; B.H. 2898, 188th Leg. (Ma. 2013), *available at* https://malegislature.gov/Bills/188/House/H2898.

[142] *See* California Transparency in Supply Chains Act of 2010, *supra* note 98.

[143] *E.g.*, PRR Framework, *supra* note 99.

[144] *See OECD Guidelines for Multinational Enterprises*, OECD Publishing (2011), *available at* http://www.oecd.org/daf/inv/mne/oecdguidelinesformultinationalenterprises.htm [hereinafter OECD Guidelines]; *ISO 26000 – Social Responsibility*, ISO (2010), *available at* http://www.iso.org/iso/home/standards/iso26000.htm [hereinafter ISO 26000].

[145] *See* EUROPEAN COMM'N, PROPOSAL FOR A DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL AMENDING COUNCIL DIRECTIVES 78/660/EEC AND 83/349/EEC AS REGARDS DISCLOSURE OF NON-FINANCIAL AND DIVERSITY INFORMATION BY CERTAIN LARGE COMPANIES AND GROUPS 207 (2013), *available at* http://ec.europa.eu/internal_market/accounting/docs/non-financial-reporting/com_2013_207_en.pdf [hereinafter European Commission Proposal]; *see also* EUROPEAN COMM'N, MEMO: DISCLOSURE OF NON-FINANCIAL AND DIVERSITY INFORMATION BY CERTAIN LARGE COMPANIES AND GROUPS (PROPOSAL TO AMEND ACCOUNTING DIRECTIVES) – FREQUENTLY ASKED QUESTIONS (2013), *available at* http://europa.eu/rapid/press-release_MEMO-13-336_en.htm [hereinafter European Commission Memo]. The European Union adopted a resolution May 23, 2013 that reinstated Burma/Myanmar's access to generalized tariff prefences, which included provisions that call on large European companies doing business in Burma/Myanmar to report on their human rights due diligence policies and proecures and calling on the European Commission to monitor the commitments made by European businesses in light of corporate social responsibility principles. *See Resolution on Reinstatement of Burma/Myanmar's Access to Generalized Tariff Preferences*, EUR. PARL. DOC. B7-0198 (2013).

[146] *E.g.*, ELECTRONIC INDUSTRY CITIZENSHIP COALITION, http://eicc.org (last visited July 25, 2013); GLOBAL E-SUSTAINABILITY INITIATIVE (GESI), http://gesi.org (last visited July 25, 2013); GLOBAL NETWORK INITIATIVE, http://globalnetworkinitiative.org (last visited July 25, 2013); RESPONSIBLE JEWELLERY COUNCIL, http://www.responsiblejewellery.com (last visited July 25, 2013); VOLUNTARY PRINCIPLES, *supra* note 102.

[147] UN GLOBAL COMPACT, http://www.unglobalcompact.org/AboutTheGC/index.html (last visited July 18, 2013).

[148] PRR Framework, *supra* note 99.

[149] Guiding Principles, *supra* note 6.

[150] *See id.* at Introduction.

[151] OECD Guidelines, *supra* note 144.

[152] ISO 26000, *supra* note 144.

[153] UN Global Compact, *Corporate Sustainability in The World Economy*, http://www.unglobalcompact.org/docs/news_events/8.1/GC_brochure_FINAL.pdf (last visited June 14, 2013).

[154] *See* UN Global Compact, *The Ten Principles*, http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/index.html (last visited June 14, 2013).

[155] *See id.*

[156] UN Global Compact, *Overview of the UN Global Compact*, http://www.unglobalcompact.org/AboutTheGC/index.html (last visited June 14, 2013).

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[167] *See id*.
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[247] *About <IR>*, IIRC, http://www.theiirc.org/about/ (last visited July 26, 2013).
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INTERNATIONAL CORPORATE
ACCOUNTABILITY ROUNDTABLE

Setting the Record Straight

Common Myths about Environmental, Social, and Governance (ESG) Reporting

Over the past few decades, investors have become increasingly concerned not only with the short term profits of their investments, but also the long-term viability of the public companies in which they invest. As a result, investor calls for corporate disclosures of a company's environmental, social, and governance (ESG) policies, practices, and impacts as a means to assess the long-term health, profitability, and viability of companies have also increased. In response, public companies have begun voluntarily disclosing ESG information, and U.S. allies and peer countries have begun to, or have already enacted, mandatory reporting on ESG issues. The United States' lack of action puts the country at risk of falling behind the global curve in mandating the disclosure of ESG issues important to investor assessment of long-term profitability. Common misconceptions about ESG reporting must be addressed in order to push forth meaningful reporting requirements that respond to investor needs.

MYTH 1: ***Only socially responsible or impact investors care about ESG issues***

Today, a wide array of investors are looking towards ESG factors as an integral part of their decision-making processes. Worldwide, investors with $68.4 trillion of capital are committed to incorporating ESG factors in their investing and voting decisions as part of the U.N. Principle for Responsible Investment ("PRI").[1] According to a recent Ernst & Young report, ESG factors are no longer a niche consideration, with "investor interest in non-financial information span[ning] across all sectors," and 61.5% of investors consider non-financial information relevant to their investments overall.[2] Accordingly, some ESG issues such as climate change or human rights are of increasing concern to investors. For example, investors with $95 trillion in invested capital support the Carbon Disclosure Project's ("CDP") annual survey of global companies regarding their greenhouse gas emissions and strategies for addressing climate change.[3] In relation to human rights, an Ernst and Young report found that 19.1% of investors would rule out an investment immediately and 63.2% would reconsider investing if there were significant human rights risks associated with the investment.[4]

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[1] *See, PRI-11 year growth of AO (all signatories (Asset Owners [sic], Investment Managers and seride [sic] providers) and respective AUM,* Excel sheet available for download at *About the PRI*, U.N. Principles for Responsible Investment, http://www.unpri.org/about.

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[4] Ernst & Young, Value of Sustainability, *supra* note 2 at 16.

MYTH 2: *ESG issues are not financially material*

ESG information is critical to assessing the long-term investment success of a company, especially in relation to assessing risks, and is therefore financially material. Numerous studies, including a June 2017 Bank of America Merrill Lynch study, found ESG factors to be "strong indicators of future volatility, earnings risk, price declines, and bankruptcies."[5] A 2014 review of empirical studies analyzing ESG data and corporate financial performance found overwhelming links between sustainability and profit: 90% of the analyzed studies showed that sound sustainability standards lowered firms' cost of capital; 80% of the studies showed that companies' stock price performance is positively influenced by good sustainability practices; and 88% of the studies showed that better ESG practices result in better operational performance.[6] These reports and statistics, coupled with the support of investors with trillions of dollars in assets under management, help to illustrate that ESG information is financially material to a reasonable investor. Furthermore, information need not be financially material, to be material to a reasonable investor.[7] There is growing global consensus that ESG disclosures should be seen from a "double materiality" perspective, as they provide both financially and environmentally/socially material information to investors.[8]

MYTH 3: *The SEC doesn't have the mandate to require ESG disclosures*

The SEC was granted broad authority by both the Securities Act and the Exchange Act to promulgate disclosure rules "as necessary or appropriate in the public interest or for the protection of investors."[9] As discussed above, ESG disclosures are material to investors, and therefore fall under the SEC's mandate of investor protection. In addition, disclosure of ESG information is also in the public interest, as it "promote[s] efficiency, competition, and capital formation."[10] Mandatory ESG disclosures would increase both informational efficiency, through the creation of consistent, comparable, and complete ESG reporting, and allocative efficiency, as investors would have a better understanding of the long-term profitability of their potential investments. These disclosures would also help U.S. markets keep their competitive edge. Today, more than twenty countries have mandated public company disclosures of certain ESG issues, and seven stock exchanges require social or environmental disclosures as a listing requirement.[11] As global investors increasingly demand and expect these types of disclosures, the SEC should also require the same in order to stay competitive. Such disclosures would increase investor confidence in the long-term profitability of U.S. markets and encourage increased capital formation in the form of new investments.

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[6] *See* Gordon L. Clark, Andreas Feiner & Michael Viehs, *From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance* (2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281.

[7] *See, e.g.* Cynthia Williams, et. al, "Knowing and Showing" Using U.S. Securities Laws to Compel Human Rights Disclosure (Oct. 2013), https://bit.ly/2FEvCSZ.

[8] European Commission, Consultation Document on the Update of the Non-Binding Guidelines on Non-Financial Reporting, https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-non-financial-reporting-guidelines-consultation-document_en.pdf.

[9] Securities Act of 1933 §§ 7, 10, and 19(a); Securities and Exchange Act of 1934 §§ 3(b), 12, 13, 14, 15(d), and 23(a).

[10] Securities Act of 1933, §2(b); Securities and Exchange Act of 1934, § 23(a)(2).

[11] *See* Initiative for Responsible Investment, *Corporate Social Responsibility Disclosure Efforts by National Governments and Stock Exchanges* (March 12, 2015), *available at* http://hausercenter.org/iri/wp-content/uploads/2011/08/CR-3-12-15.pdf.

MYTH 4: *ESG disclosures would be too costly for reporting companies*

The value of complete, comparable, and consistent ESG disclosures far outweighs any related costs. Studies have shown that companies with strong disclosure practices have positive shareholder returns and better stock returns.[12] Additionally, a majority of the largest companies are currently making voluntary sustainability disclosures, with 85% of S&P 500 companies producing such reports in 2017.[13] Costs associated with larger companies are usually higher given complex supply chains and global operations. That a number of large companies are already disclosing ESG information voluntarily reinforces the notion that the benefits of ESG reporting outweigh the associated costs and that the cost of shifting from voluntary to mandatory reporting would be minimal.

MYTH 5: *Voluntary ESG disclosures already provide investors what they need to know*

While a range of reporting standards exist for voluntary disclosure of ESG information, the application and consistency of these standards varies greatly. This variability makes it difficult for investors to compare ESG data across companies or time, hindering the effectiveness of such disclosures for investment decision-making.[14] Without a regulatory mandate, voluntary disclosures are often incomplete, inconsistent, and not comparable. The SEC has recognized the value and importance of standardized disclosures for these same reasons.[15] When reporting becomes mandatory, standards necessarily become clearer, and the disclosed information more relevant and pertinent to investor needs.

For more information, please contact Jana Morgan, Director of Campaigns and Advocacy, at Jana@icar.ngo.

The International Corporate Accountability Roundtable (ICAR) harnesses the collective power of progressive organizations to push governments to create and enforce rules over corporations that promote human rights and reduce inequality.

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[12] See, Andy Green & Andrew Schwartz, Corporate Long-Termism, Transparency, and the Public Interest (2018); Gordon L. Clark, et. al, *From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance, supra* note 6.

[13] Governance and Accountability Institute Inc., "85% of the S&P 500 Index Companies Publish Sustainability Reports in 2017" (2018), available at https://www.ga-institute.com/press-releases/article/flash-report-82-of-the-sp-500-companies-published-corporate-sustainability-reports-in-2016.html.

[14] See, e.g. Jim Coburn & Jackie Cook, Cool Response: The SEC & Corporate Climate Change Reporting (2014). See also, David Levy, Halina S. Brown, & Martin de Jong, The Contested Politics of Corporate Governance: The Case of the Global Reporting Initiative, 49 BUS. & SOC'Y 88 (2010); Carl-Johan Hedberg & Fredrik von Malmborg, The Global Reporting Initiative and Corporate Sustainability Reporting in Swedish Companies, 10 CORP. SOC. RESP. & ENVTL. MGMT. 153 (2003).

[15] See Chair Mary Jo White, Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility," Dec. 9, 2015, available at http://www.sec.gov/news/speech/keynote-2015-aicpa-white.html

Why Enhanced Securities Disclosures Matter for Long-Termism

Environmental, social, and governance (ESG) reporting provides critical information to investors that helps to guide their investment decisions, and as such is critical for the long-term health and well-being of a public company. These disclosures are essential for companies that want to be seen as good corporate citizens. When a company is transparent around these important issues it often receives a reputational boost and greater access to capital. ***The Securities and Exchange Commission should initiate a rulemaking to ensure that ESG disclosures are comprehensive, consistent, and comparable.***

1) **Strong disclosure reporting is the new normal, and a smart business strategy**

ESG reporting has become a common practice of the twenty-first century business. In 2013, 44% of investors in stock markets worldwide either mandated or strongly encouraged corporate ESG reporting. This drove ESG disclosure to become standard practice – today, 75% of 4,900 companies studied by KPMG issue ESG reports and 78% of the world's 250 largest companies disclose such data in their annual financial reports. Some countries also require pension funds to consider ESG factors as a part of their fiduciary responsibilities. Choosing not to align reporting is choosing the path to less competitiveness, or worse, it is choosing to be presumed a laggard in global best practices, which could hurt corporate brands with investors and the consumers. As Christopher Meyer said: "we now live in the age of transparency where companies that do not own up to their responsibilities will find themselves in the worst of all worlds where they will be *made* responsible and still not *considered* responsible."

2) **Enhanced reporting of environmental, social, and governance risks boosts corporate reputation and creates a competitive *advantage***

Major scandals such as the Rana Plaza collapse in Bangladesh, Target's political donations, and BP's Deepwater Horizon oil spill in the Gulf of Mexico have yielded ever-growing consumer demands that corporations be honest with their consumers and investors, who clearly care about ESG reporting. Nearly 9-in-10 consumers in the richest countries in the world believe corporations should make clear, searchable disclosures and be held accountable for reporting and communicating the findings. Corporations that do are rewarded: more than 50% of corporations engaging in ESG reporting noticed it helped boost company reputation. ESG reporting indeed permits corporations to brand themselves as good corporate citizens and ensures that they are not unfairly linked to abuses.

3) **ESG information is *material* to a broad range of investors and provides corporations with increased access to capital**[1]

Today investors worth nearly $30 trillion in financial assets have signed the United Nations Principles for Responsible Investment, and are actively looking to invest in companies with high ESG performance - ESG disclosure and financial returns go hand in hand. As the responsible investment space is growing, good corporate citizens stand to benefit from additional access to capital, whereas corporations that do not may miss out. ESG disclosure plays an ever-increasing pivotal role in 320 global investors' decision-making processes. In 2016, 68% affirmed having frequently made an investment decision based on ESG information during the year. Larry Fink, the CEO of BlackRock, with $6 trillion under management recently strongly encouraged companies to make long-term planning a priority, focusing on ESG factors, and also indicated BlackRock would not hesitate to back activists in proxy ballot fights on these issues if corporations resist. ESG reporting in this context is especially important as responsible investors need "measurable and comparable" indicators as benchmarks against which to compare a wide range of companies.

Please contact Jana Morgan, International Corporate Accountability Roundtable (ICAR) at jana@icar.ngo
or 703-795-8542 with any questions.

[1] *TSC v. Northway* 426 U.S. 438, 449 (1976): a "reasonable shareholder would consider important in deciding how to vote."

March 23, 2018

LETTER SUBMITTED BY PUBLIC CITIZEN

215 Pennsylvania Avenue, SE • Washington, D.C. 20003 • 202/546-4996 • www.citizen.org

April 1, 2019

Chairman Mike Crapo
Ranking Member Sherrod Brown
Members of the Committee
U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Crapo, Ranking Member Brown, and Members of the Committee,

Public Citizen respectfully offers the following comments to the record for the hearing titled "The Application of Environmental, Social, and Governance Principles in Investing and the Role of Asset Managers, Proxy Advisors, and Other Intermediaries." We applaud the committee for looking closely at this issue, and we enclose the public petition for a rulemaking that has been submitted to the Securities and Exchange Commission (SEC) calling for the agency to issue a standard disclosure framework on all environmental, social, and governance (ESG) issues for public companies. The rulemaking petition was submitted by investors representing more than $5 trillion in assets under management including:

- California Public Employees' Retirement System (CalPERS)
- New York State Comptroller Thomas P. DiNapoli
- Illinois State Treasurer Michael W. Frerichs
- Connecticut State Treasurer Denise L. Nappier
- Oregon State Treasurer Tobias Read
- U.N. Principles for Responsible Investment

The petition was drafted with the guidance of American securities law experts Professor Cynthia Williams, who is currently at Toronto's Osgoode Hall Law School, and Professor Jill Fisch of the University of Pennsylvania Law School.

For years, investors have been calling upon the SEC to require companies to disclose various types of ESG risks from climate, to human capital management, to political spending, to tax, to human rights, to gender pay ratios. Moreover, in response to increasing demands from investors for this information as connected to long- term performance and risk management, many companies have been attempting to provide this information voluntarily. However, the lack of parameters for the nature, timing, and extent of these voluntary disclosures makes it impossible

for investors to compare companies and make smart investment decisions. The only way to fill this void is for the SEC to issue comprehensive, standard guidance for public companies' disclosure of ESG risk, which would create a uniform requirement, as called for in the submitted petition.

The SEC has clear statutory authority to require this type of disclosure, and doing so will promote market efficiency, protect the competitive position of American public companies and the U.S. capital markets, and enhance capital formation.

While we applaud the companies that do choose to volunteer ESG information, they often do so in a manner that is episodic, incomplete, incomparable, and inconsistent. By issuing standard disclosure rules, the SEC will reduce the current burden on public companies, allowing them to plan for providing information that is relevant, reliable, and decision-useful. This will provide a level playing field for the many American companies engaging in voluntary ESG disclosure.

ESG information is material to a broad range of investors. Today, investors with $68.4 trillion of capital are committed to incorporating ESG factors in their investing and voting decisions as part of the U.N. Principles for Responsible Investment. Moreover, global assets under management utilizing sustainability screens, ESG factors, and comparable SRI corporate engagement strategies were valued at $22.89 trillion at the start of 2016, which comprised 26% of all professionally managed assets globally.

While Public Citizen takes the stance that investors have a right to a broad range of ESG disclosure, one issue that we have focused on specifically for almost a decade is corporate political activity.

A company's political activity- both its election spending and lobbying- is relevant to its shareholders because it can present significant reputational risk if not disclosed and managed properly. Many customers and the purchasing public are paying close attention to whether a company's political activity lines up with its corporate values. If there is a disconnect companies can face bad press, boycotts, or targeted social media campaigns.

For example, AT&T came under public scrutiny after it was revealed that the company paid attorney Michael Cohen--who has since been sentenced to three years in prison for campaign finance violations and fraud--$600,000 to consult on policy matters without disclosing that information to shareholders. This was following five years of calls from AT&T's shareholders to disclose the full extent of its lobbying activity and oversight policies, including payments for direct and indirect lobbying. Clearly shareholders were right to make this demand. It is important for companies to be transparent in order to prove corporate integrity and reputational soundness.

Shareholder proposals calling on companies to be honest about their political activity are one of the most frequently filed proposals every year, with 93 filed at the start of the 2019 proxy season. Further, more and more companies are adopting accountability and transparency policies because

they see this demand. Currently, more than half of the S&P 100 companies are disclosing some or all of their election- related contributions with corporate money.

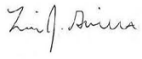
In 2011, a group of securities law experts filed a petition with the SEC calling for a rulemaking on corporate political spending disclosure. Since being filed the petition has received more than the 1.2 million comments from significant experts and stakeholders such as John C. Bogle, founder and former CEO of the Vanguard Group; five state treasurers; a bipartisan group of former SEC Commissioners and Chairs; members of Congress; and 79 charitable foundations.

In addition to the comments that have poured in to the political spending disclosure petition, the SEC received over 26,500 comments in response to its 2016 Concept Release on Business and Financial Disclosure Required by Regulation S-K, the overwhelming majority of which expressed a demand for more and better disclosure in general. Additional petitions and stakeholder engagement seeking different kinds of ESG information suggest, in aggregate, that it is time for the SEC to regulate in this area.

Public Citizen disagrees with the notion that investors experience "information overload" in the current disclosure regime. While it is incredibly important that corporate disclosures are clear, concise, and decision-useful for investors, they have the right to the material information they demand. To cite Commissioner Peirce in her speech at the University of Michigan Law School on September 24th, 2018, "the Commission serves the public interest not by making decisions for people, but by enabling them to make decisions for themselves." Having access to a broad range of information about a company is a key way for investors to make smart decisions. Furthermore, if a company already has strong oversight of its political activity, for example, why wouldn't it share that information with its shareholders?

Public Citizen has been encouraging the Commission to promptly initiate a rulemaking to develop mandatory rules for public companies to disclose high-quality, comparable, decision-useful environmental, social, and governance information, and we encourage Congress to join our call to the agency.

Sincerely,



Lisa Gilbert
Vice President of Legislative Affairs
Public Citizen

Rachel Curley
Democracy Associate
Public Citizen's Congress Watch Division

October 1, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, Northeast
Washington, DC 20549

Dear Mr. Fields:

Enclosed is a petition for a rulemaking on environmental, social, and governance (ESG) disclosure authored by Osler Chair in Business Law Cynthia A. Williams, Osgoode Hall Law School, and Saul A. Fox Distinguished Professor of Business Law Jill E. Fisch, University of Pennsylvania Law School, and signed by investors and associated organizations representing more than $5 trillion in assets under management including the California Public Employees' Retirement System (CalPERS), New York State Comptroller Thomas P. DiNapoli, Illinois State Treasurer Michael W. Frerichs, Connecticut State Treasurer Denise L. Nappier, Oregon State Treasurer Tobias Read, and the U.N. Principles for Responsible Investment.

The enclosed rulemaking petition:

- Calls for the Commission to initiate notice and comment rulemaking to develop a comprehensive framework requiring issuers to disclose identified environmental, social, and governance (ESG) aspects of each public-reporting company's operations;
- Lays out the statutory authority for the SEC to require ESG disclosure;
- Discusses the clear materiality of ESG issues;
- Highlights large asset managers' existing calls for standardized ESG disclosure;
- Discusses the importance of such standardized ESG disclosure for companies and the competitive position of the U.S. capital markets; and
- Points to the existing rulemaking petitions, investor proposals, and stakeholder engagements on human capital management, climate, tax, human rights, gender pay ratios, and political spending, and highlights how these efforts suggest, in aggregate, that it is time for the SEC to bring coherence to this area.

If the Commission or Staff have any questions, or if we can be of assistance in any way, please contact either **Osler Chair in Business Law Cynthia A. Williams**, Osgoode Hall Law School, who can be reached at (416) 736-5545, or by electronic mail at cwilliams@osgoode.yorku.ca; or **Saul A. Fox Distinguished Professor of Business Law Jill E. Fisch**, University of Pennsylvania Law School, who can be reached at (215) 746-3454, or by electronic mail at jfisch@law.upenn.edu.

October 1, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, Northeast
Washington, DC 20549

Dear Mr. Fields,

We respectfully submit this petition for rulemaking pursuant to Rule 192(a) of the Securities and Exchange Commission's (SEC) Rule of Practice.[1]

Today, investors, including retail investors, are demanding and using a wide range of information designed to understand the long-term performance and risk management strategies of public-reporting companies. In response to changing business norms and pressure from investors, most of America's largest public companies are attempting to provide additional information to meet these changing needs and to address worldwide investor preferences and regulatory requirements. Without adequate standards, more and more public companies are voluntarily producing "sustainability reports" designed to explain how they are creating long-term value. There are substantial problems with the nature, timing, and extent of these voluntary disclosures, however. Thus, we respectfully ask the Commission to engage in notice and comment rule-making to develop a comprehensive framework for clearer, more consistent, more complete, and more easily comparable information relevant to companies' long-term risks and performance. Such a framework would better inform investors, and would provide clarity to America's public companies on providing relevant, auditable, and decision-useful information to investors.

Introduction

In 2014, the Commission solicited public comments to its "Disclosure Effectiveness" initiative, which sought to evaluate and potentially reform corporate disclosure requirements. Over 9,835 commenters have responded to that initiative.[2] As part of that initiative, the 2016 Concept Release on Business and Financial Disclosure Required by Regulation S-K ("Concept Release")[3] solicited public opinions on the frequency and format of current disclosure, company accounting practices and standards, and the substantive issues about which information should be disclosed. In that Concept Release, the SEC asked a number of questions about whether it should require disclosure of sustainability matters, which it defined as "encompass[ing] a range of topics, including climate change, resource scarcity, corporate social responsibility, and good

[1] Rule 192. Rulemaking: Issuance, Amendment and Repeal of Rules, Rule 192(a), *By Petition*, *available at* https://www.sec.gov/about/rules-of-practice-2016.pdf.
[2] *See* Tyler Gellasch, *Joint Report: Towards a Sustainable Economy: A review of Comments to the SEC's Disclosure Effectiveness Concept Release*, 14 (Sept. 2016), [hereinafter "Gellasch Joint Report"], *available at:* https://static1.squarespace.com/static/583f3fca725e25fcd45aa446/t/5866d3c0725e25a97292ae03/1483133890503/Sustainable-Economy-report-final.pdf.
[3] Business and Financial Disclosure Required by Regulation S-K, Release No. 33-10064; 34-77599; File No. S7-06-16, April 16, 2016, *available at* https://www.sec.gov/rules/concept/2016/33-10064.pdf [hereinafter "Concept Release"].

corporate citizenship. These topics are characterized broadly as ESG [Environmental, Social, and Governance] concerns."[4]

The SEC received over 26,500 comments in response to the 2016 Concept Release, making it one of only seven major proposals by the SEC since 2008 to garner more than 25,000 comments.[5] As noted in a report reviewing comments to the Concept Release, "the overwhelming response to the Concept Release seems to reflect an enormous pent up demand by disclosure recipients for more and better disclosure" generally.[6] The Concept Release also provided the first formal opportunity since the mid-1970s for both reporting companies and disclosure recipients to convey their views to the SEC concerning what additional environmental or social information should be disclosed to complement the governance disclosure already required.

An analysis of the comments submitted in response to the Concept Release, a significant majority of which supported better ESG disclosure, can be found in the report referenced in footnote 2. Across the board, commenters noted how they were using those disclosures to understand companies' potential long-term performance and risks. The response to the Concept Release strongly suggests that it is time for the Commission to engage in a rulemaking process to develop a framework for public reporting companies to use to disclose specific, much higher-quality ESG information than is currently being produced pursuant either to voluntary initiatives or current SEC requirements.

We briefly set out six arguments supporting this petition:

(1) The SEC has clear statutory authority to require disclosure of ESG information, and doing so will promote market efficiency, protect the competitive position of American public companies and the U.S. capital markets, and enhance capital formation;

(2) ESG information is material to a broad range of investors today;

(3) Companies struggle to provide investors with ESG information that is relevant, reliable, and decision-useful;

(4) Companies' voluntary ESG disclosure is episodic, incomplete, incomparable, and inconsistent, and ESG disclosure in required SEC filings is similarly inadequate;

(5) Commission rulemaking will reduce the current burden on public companies and provide a level playing field for the many American companies engaging in voluntary ESG disclosure; and

(6) Petitions and stakeholder engagement seeking different kinds of ESG information suggest, in aggregate, that it is time for the SEC to regulate in this area.

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[4] *See id.* at 206.
[5] *Id.*
[6] *See* Joint Report, *supra* note 2, at 10.

1. *The SEC has Clear Statutory Authority to Require Disclosure of ESG Information*

As acknowledged by the SEC in its Concept Release, its statutory authority over disclosure is broad. Congress, in both the Securities Act and the Exchange Act, "authorize[d] the Commission to promulgate rules for registrant disclosure 'as necessary or appropriate in the public interest or for the protection of investors.'"[7] In an early defense of its power to require disclosure of corporate governance information such as the committee structure and composition of boards of directors—disclosure now considered standard, but which was controversial when the requirements were first promulgated—the SEC was explicit about the broad scope of its power over disclosure:

> The legislative history of the federal securities laws reflects a recognition that disclosure, by providing corporate owners with meaningful information about the way in which their corporations are managed, may promote the accountability of corporate managers. . . . Accordingly, although the Commission's objective in adopting these rules is to provide additional information relevant to an informed voting decision, it recognizes that disclosure may, depending on determinations made by a company's management, directors and shareholders, influence corporate conduct. This sort of impact is clearly consistent with the basic philosophy of the federal securities laws.[8]

In 1996, Congress added Section 2(b) to the Securities Act of 1933, and Section 23(a)(2) to the Securities and Exchange Act of 1934. These parallel sections provide that:

> Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[9]

These statutory policy goals underscore the SEC's authority to require disclosure of better, more easily comparable, and consistently presented ESG information. Generally, the SEC seeks to protect investors through requirements for issuers to disclose material information at specified times.[10] Thus, the investor protection aspect of the SEC's statutory authority will be discussed in Part Two, below, in conjunction with the discussion of the materiality of ESG information. Here we discuss why requiring issuers to disclose specified ESG information would promote market efficiency, competition, and capital formation.

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[7] Concept Release, *supra* note 3, at 22-23 & fn. 50, *citing* Sections 7, 10, and 19(a) of the Securities Act of 1933, 15 U.S.C. §§ 77g(a)(10), 77j, and 77s(a); and Sections 3(b), 12, 13, 14, 15(d), and 23(a) of the Securities and Exchange Act of 1934, 15 U.S.C. §§ 78c(b), 78l, 78m(a), 78n(a), 78o(d), and 78w(a).

[8] Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 15,384, 16 Docket 348, 350 (Dec. 6, 1978).

[9] Securities Act of 1933, §2(b), 15 U.S.C.§ 77b(b); Securities and Exchange Act of 1934, § 23(a)(2), 15 U.S.C. §78w(a)(2)(2012).

[10] *See* Concept Release, *supra* note 3, at 23 (stating that "our disclosure rules are intended not only to protect investors but also to facilitate capital formation and maintain fair, orderly and efficient capital markets.").

A. Promoting Efficient Capital Markets

The concept of "efficient capital markets" includes informational efficiency (market mechanisms able to process new information quickly and with broad distribution)[11] and allocative efficiency (distributing capital resources to their highest value use at the lowest cost and risk).[12] Disclosure is obviously relevant to both efficiency goals, the latter being particularly relevant to the discussion of the need for better sustainability disclosure. As Mark Carney, Governor of the Bank of England and Chair of the Financial Stability Board, said with respect to climate change, with "consistent, comparable, reliable, and clear disclosure" of firms' forward-looking strategies, both "markets and governments" can better manage the transition to a low-carbon future by supporting the allocation of capital to its risk-adjusted highest-value use in that transition.[13] Climate change is not a purely environmental issue, of course: It is also an issue that poses material risks and opportunities to companies in most industries. The Sustainability Accounting Standards Board ("SASB")'s conclusion, developed in conjunction with industry leaders, is that 72 of 79 industries, representing 93% of U.S. capital market valuations, are vulnerable to material financial implications from climate change.[14] The point is that without consistent, comparable, reliable, and complete information, capital markets are constrained in promoting allocational efficiency as many industries embark on the transition to a low-carbon economy. Similarly, other substantial social and economic challenges in the United States, such as increasingly precarious work environments, rising economic inequality, or the security of private information, can be better perceived by investors and assets allocated to high-performance workplaces and firms with better human capital management and cybersecurity arrangements if investors are provided with clear and comparable information about these matters.

Requiring firms to disclose more ESG information is thus consistent with the SEC's authority to promote market efficiency, and within its broad mandate "to promulgate rules for registrant disclosure as necessary or appropriate in the public interest or for the protection of investors."[15]

B. Ensuring the global competitiveness of America's public companies and the U.S. capital markets

The SEC will also be ensuring the competitiveness of U.S. capital markets and America's public companies by requiring more ESG disclosure. Many other developed countries have already promulgated such requirements, shaping the expectations of global investors. A 2016 study by the U.N. PRI (Principles for Responsible Investment) and MSCI (a global data and investment research provider) identified 300 policy initiatives promoting sustainable finance in the world's 50 largest economies, of which 200 were corporate reporting requirements covering

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[11] *See* Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK L.REV. 763, 764–65 (1995).
[12] *See* Alicia J. Davis, *A Requiem for the Retail Investor?*, 95 VA. L. REV. 1105, 1116 (2009) (recognizing that "[p]ublic markets perform a vital economic role, since accurate share prices lead to the efficient allocation of capital.").
[13] Mark Carney, Governor, *Breaking the tragedy of the horizon: Climate change and financial stability,* Bank of England 14 (Sept. 29, 2015), *available at* http://www.BankofEngland.co.uk/publications/Pages/speeches/2015/844.asp#.
[14] Sustainability Accounting Standards Board, *Climate Risk—Technical Bulletin,* SASB Library 2017, *available at* https://library.sasb.org/climate-risk-technical-bulletin/.
[15] Concept Release, *supra* note 3, at 22.

environmental, social, and governance factors.[16] According to a 2015 report by the Initiative for Responsible Investment of the Hauser Institute for Civil Society at the Kennedy School, Harvard University, 23 countries have enacted legislation within the last 15 years to require public companies to issue reports including environmental and/or social information.[17]

In addition to these reporting initiatives, seven stock exchanges require social and/or environmental disclosure as part of their listing requirements: Australia's ASX, Brazil's Bovespa, India's Securities and Exchange Board, the Bursa Malaysia, Oslo's Børs, the Johannesburg Stock Exchange, and the London Stock Exchange.[18]

Moreover, seven countries have enacted policies following those of the U.K. and Sweden, which since 2000 have required public pension funds to disclose the extent to which the fund incorporates social and environmental information into their investment decisions.[19] Regulations such as these support the trend of increasing institutional investor demand for high-quality ESG data, as discussed below. Currently the European Union is developing a taxonomy of environmentally sustainable activities, as well as developing benchmarks for low-carbon investment strategies, and regulatory guidance to improve corporate disclosure of climate-related information.[20] To the extent that US companies fail to disclose information which global investors are being encouraged, and in some cases required, to consider, they will be at a disadvantage in attracting capital from some of the world's largest financial markets. This highlights that US corporate reporting standards will soon become outdated if they are not revised to incorporate global developments regarding the materiality and disclosure of ESG information.

C. Facilitating Capital Formation

Additionally, promulgating a regulatory framework for the disclosure of ESG information would promote capital formation. By providing more information to investors, giving better information about risks and opportunities, and standardizing what is currently an uncoordinated and irregular universe of ESG disclosures, the SEC would act to increase confidence in the capital markets. This confidence may well mobilize sources of capital from investors who are currently unwilling to invest given knowledge gaps or information asymmetries. Particularly retail investors, who are important as long-term investors and investors in small and medium enterprises, may be emboldened by a clearer sense of the social and environmental aspects of

[16] PRI and MSCI, *Global Guide to Responsible Investment Regulation,* 2016, *available at* https://www.unpri.org/page/responsible-investment-regulation.

[17] *See* Initiative for Responsible Investment, *Corporate Social Responsibility Disclosure Efforts by National Governments and Stock Exchanges* (March 12, 2015), *available at* http://hausercenter.org/iri/wp-content/uploads/2011/08/CR-3-12-15.pdf. These countries include Argentina, China, Denmark, the EU, Ecuador, Finland, France, Germany Greece, Hungary, India, Indonesia, Ireland (specific to state-supported financial institutions after the 2008 financial crisis), Italy, Japan, Malaysia, The Netherlands, Norway, South Africa, Spain, Sweden, Taiwan, and the U.K.

[18] *See id.*

[19] *See* Initiative for Responsible Investment report, *supra* note 63. These countries include Australia, Belgium, Canada, France, Germany, Italy, and Japan.

[20] Technical Expert Group on Sustainable Finance (TEG), *State-of-play, July 2018, available at* https://ec.europa.eu/info/publications/sustainable-finance-technical-expert-group_en.

companies' activities as a guide to companies' longer-term risks and opportunities.[21] As we highlight below, the value of assets under management based on ESG-influenced guidelines has grown considerably in the past two decades. We ask the SEC to act to facilitate the provision of information to this rapidly growing sector. In so doing, additional capital may become available to support America's enterprises, particularly its smaller and medium-sized enterprises.

2. *ESG Information is Material and Decision Useful*

In advancing its over-arching goals of investor protection and promoting market efficiency, the SEC has relied upon the concept of materiality to determine what information issuers should be required to disclose and in what format.[22] As defined by the U.S. Supreme Court in *TSC v. Northway,* material information is information that a "reasonable shareholder would consider important in deciding how to vote."[23] As the Court said, "[p]ut another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[24] Thus, what is material depends on reasonable investors' perceptions of what information is already available in the market, and how any new or omitted information changes those perceptions of the quality of management, when voting or engaging with management, or the value of a company or its shares, when investing or selling.

In promulgating disclosure regulations under Regulation S-K, the SEC has predominantly, but not exclusively, sought to require the disclosure of information it construes as financially material.[25] Recent investment industry analyses are confirming the financial materiality of much ESG information. For instance, a June, 2017, Bank of America Merrill Lynch study highlighted by the Sustainability Accounting Standards Board found sustainability factors to be "strong indicators of future volatility, earnings risk, price declines, and bankruptcies."[26] Also in June of 2017, Allianz Global Investors produced a research report with similar findings, concluding that the heightened transparency of ESG disclosure lowered companies' cost of capital by reducing the "investment risk premium" that sophisticated investors would require.[27] In September of 2017, Nordea Equity Research published an analytic research report concluding that there is "solid evidence that ESG matters, both for operational and share price performance."[28] Goldman Sachs concluded in April of 2018 that "integrating ESG factors allows for greater insight into

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[21] *See* Davis, *supra* note 12, at 116-1120 for evidence on the importance of retail investors to small and medium enterprises, versus institutional investors which predominantly invest in large-capitalization companies; and for evidence of retail investors generally longer holding periods for shares of stock.
[22] Concept Release, *supra* note 3, at 33-34.
[23] 426 U.S. 438, 449 (1976).
[24] *Id.*
[25] *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1264-66 (1999) (discussing SEC's requirements for public companies to disclose certain corporate governance information without a showing of economic materiality).
[26] Bank of American Merrill Lynch, *Equity Strategy Focus Point—ESG Part II: A Deeper Dive* (June 15, 2017), *cited in* Sustainability Accounting Standards Board (SASB), *The State of Disclosure Report 2017* (December 2017).
[27] Allianz Global Investors, *ESG matters, Part 2: Added value or a mere marketing tool?What does ESG mean for investments?,* (June 2017).
[28] Nordea Equity Research, *Strategy & Quant: Cracking the ESG Code,* 5 Sept. 2017, *available at:* https://nordeamarkets.com/wp-content/uploads/2017/09/Strategy-and-quant_executive-summary_050917.pdf.

intangible factors such as culture, operational excellence and risk that can improve investment outcomes."[29]

These industry studies are consistent with, and indeed rely upon, a number of influential academic studies that have analyzed the over 2,000 research studies also showing the economic materiality of ESG information. Two such studies are of particular note. Deutsch Asset & Wealth Management, in conjunction with researchers from the University of Hamburg, analyzed 2,250 individual studies of the relationship between ESG data and corporate financial performance. From this analysis, the researchers concluded that improvements in ESG performance generally lead to improvements in financial performance.[30] A comprehensive review published in 2015 of empirical studies found that 90% of studies show that sound sustainability standards lower firms' cost of capital; 80% of studies show that companies' stock price performance is positively influenced by good sustainability practices; and 88% of studies show that better E, S, or G practices result in better operational performance.[31]

In addition, the SEC has promulgated disclosure requirements for the production of qualitatively material information. For instance, it has required disclosure concerning corporate governance, such as statistics on board members' attendance at meetings, and information on the committee structure of the board of directors, with the stated purpose of encouraging the board to be more active and independent in monitoring management's actions.[32] It has required extensive disclosure of executive compensation, starting in the early 1990s, as a response to public frustration with the levels of executive compensation.[33] Indeed, with respect to illegal actions by members of management or the company, the SEC has established an almost *per se* materiality standard even where the economic consequences of management's illegal actions were trivial.[34] This qualitative approach to the materiality of information concerning the honesty of management or its approach to law compliance, among other matters, was the basis for the SEC's Division of Corporation Finance and the Office of the Chief Accountant to reject

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[29] Goldman Sachs Equity Research, *GS Sustain ESG Series: A Revolution Rising-From Low Chatter to Loud Roar [Redacted]*, 23 April 2018 (analyzing earnings call transcripts, social media, asset manager initiatives, and rising assets under management utilizing ESG screens to conclude that "the ESG Revolution is just beginning, as the logical, empirical and anecdotal evidence for its importance continue to mount.").

[30] Deutsche Asset & Wealth Management, *ESG and Corporate Financial Performance: Mapping the Global Landscape*, December, 2015, *available at* https://institutional.deutscheam.com/content/_media/K15090_Academic_Insights_UK_EMEA_RZ_Online_151201_Final_(2).pdf.

[31] *See* Gordon L. Clark, Andreas Feiner & Michael Viehs, *From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance* (2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281. This report is an excellent resource because it analyzes the empirical literature on the financial effects of sustainability initiatives by type of initiative (E, S or G) and by various financial measures of interest (cost of debt capital; cost of equity capital; operating performance; and effect on stock prices).

[32] *See* Williams, *supra* note 24, at 1265 & fn. 359, *citing* Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 15,384, 16 Docket 348 (Dec. 6, 1978).

[33] *See id.* at 1266 & fn. 363, *citing* Executive Compensation Disclosure, Securities Act Release No. 6962, Exchange Act Release No. 31,327, 52 SEC Docket 1961 (Nov. 4, 1992).

[34] *See id.* at 1265 & fn. 361, *citing* Division of Corporation Finance's Views and Comments on Disclosure Relating to the Making of Illegal Campaign Contributions by Public Companies and/or their Officers and Directors, Securities Act Release No. 5466, Exchange Act Release No. 10673, 3 SEC Docket 647 (Mar. 19, 1974); *In re* Franchard Corp., 42 S.E.C. 163, 172 (1964) (Cary, Chair)(stating that the integrity of management "is always a material factor.").

quantitative benchmarks as the sole determinant to assess materiality in preparing financial statements.[35]

The Commission has often developed new disclosure requirements in response to increased investor interest in emerging systemic environmental or social risks, such as its 2011 guidance on disclosure of risks related to cybersecurity.[36] We thus conclude that the SEC properly recognizes that there can be material information which is not yet required to be reflected in financial statements but which may be decision-relevant to investors. As stated by Alan Beller, former Director of the Division of Corporation Finance, "[i]n today's rapidly changing business landscape, investors often look beyond financial statement to understand how companies create long-term value. Financial reporting today has not kept pace with both company managers and investors' interest in broader categories of information that are also material to operations and financial performance." [37] The touchstone is the "reasonable investor," and what information the reasonable investor relies upon in voting, investing, and engagement with portfolio companies.

Today, investors with $68.4 trillion of capital are committed to incorporating ESG factors in their investing and voting decisions as part of the U.N. PRI.[38] Institutions, pension funds, sovereign wealth funds, and mutual funds with $95 trillion of invested capital support the Carbon Disclosure Project's ("CDP") annual survey of global companies regarding their greenhouse gas emissions and strategies for addressing climate change.[39] According to a recent Ernst & Young report, "investor interest in non-financial information spans across all sectors," and 61.5% of investors consider non-financial information relevant to their investments overall.[40]

Global assets under management utilizing sustainability screens, ESG factors, and comparable SRI corporate engagement strategies were valued at $22.89 trillion at the start of 2016, comprising 26% of all professionally managed assets globally.[41] Moreover, U.S.-domiciled assets using SRI strategies in 2016 were valued at $8.72 trillion, comprising more than 21% of the assets under professional management in the U.S. in that year.[42] These latter data starkly contrast with the facts when the SEC last considered the issue of expanded social and environmental disclosure in comprehensive fashion, between 1971 and 1975. Then, there were two active "ethical funds" in the United States, which by 1975 collectively held only $18.6 million assets under management, or 0.0005% of mutual fund assets.[43]

The data in the last two paragraphs indicate that substantial assets under management are

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[35] *See* SEC Staff Accounting Bulletin 99-Materiality (Aug. 12, 1999).
[36] Securities & Exchange Comm'n, *Commission Guidance Regarding Disclosure Related to Topic No. 2 Cybersecurity* (Oct. 13, 2011), *available at* http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.
[37] Alan Beller, Foreword to SASB's Inaugural Annual State of Disclosure Report, December 1, 2016, *available at* https://www.sasb.org/blog-alan-beller-pens-forward-inaugural-annual-state-disclosure-report.
[38] *See PRI-11 year growth of AO, all signatories (Asset Owners, Investment Managers and service providers) and respective AUM,* Excel sheet available for download at *About the PRI*, U.N. Principles for Responsible Investment, http://www.unpri.org/about.
[39] *Catalyzing business and government action,* Carbon Disclosure project, https://www.cdp.net/en-US/Pages/About-Us.aspx.
[40] *Id.* at 18.
[41] *See* Global Sustainable Investment Alliance, *The Global Sustainable Investment Review 2016* 3, 7-8, *available at* http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIA_Review_2016.pdf.
[42] *Sustainable and Impact Investing in the United States: Overview,* US SIF, http://www.ussif.org/files/Infographics/Overview%20Infographic.pdf (last visited Nov. 9, 2017).
[43] *See* Williams, *supra* note 24, at 1267 (citing SEC data).

using what ESG data is available, clearly demonstrating that investors consider this information material.[44] And yet, as discussed below, leading U.S. asset managers and executives emphasize that the poor quality of ESG data does not meet investors' needs, and support regulatory mandates to require companies to produce better ESG data.

3. *Companies struggle to provide investors with ESG information that is relevant, reliable, and decision-useful*

Over the last twenty-five years, voluntary disclosure of ESG information, and voluntary frameworks for that disclosure, have proliferated to meet the demands for information from investors, consumers, and civil society. The most comprehensive source of data on ESG reporting is that done by KPMG in the Netherlands. KPMG published its first ESG report in 1993, and its most recent report in 2017. In 1993, 12% of the top 100 companies in the OECD countries (excluding Japan) published an environmental or social report.[45] By 2017, 83% of the top 100 companies in the Americas publish a corporate responsibility report, as do 77% of top 100 companies in Europe and 78% in Asia.[46] Of the largest 250 companies globally, reporting rates are 93%.[47] The Global Reporting Initiative's (GRI) voluntary, multi-stakeholder framework for ESG reporting has emerged as the clear global benchmark: 75% of the Global 250 use GRI as the basis for their corporate responsibility reporting.[48] Of particular note, 67% of the Global 250 now have their reports "assured," most often by the major accontancy firms.[49]

Although 75% of the Global 250 use GRI as the basis for reporting, academic studies of reporting according to GRI have found serious problems with the quality of the information being disclosed. One study comparing GRI reports in the automotive industry concluded that "the information . . . is of limited practical use . . .Thus, quantitative data are not always gathered systematically and reported completely, while qualitative information appears unbalanced."[50] Markus Milne, Amanda Ball, and Rob Gray surveyed the existing literature on GRI as a preeminent example of triple bottom line reporting, and concluded in 2013 that "the quality—and especially the *completeness*—of many triple bottom line reports are not high. . . With a few notable exceptions, the reports cover few stakeholders, cherry pick elements of news, and generally ignore the major social issues that arise from corporate activity…."[51] Other studies have observed similar problems, particularly with the lack of comparability of the information

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[44] For further evidence of investors' views on the materiality of ESG data, *see* Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, GEO. L. J. (forthcoming 2018), *available at* https://ssrn.com/abstract=3233053.

[45] *See* Ans Kolk, *A Decade of Sustainability Reporting: Developments and Significance*, 3 INT'L J. ENVIR. & SUSTAINABLE DEVELOPMENT 51, 52 Figure 1 (2004). KPMG has changed the format of the report since its original 1993 report, so direct comparisons are not possible between the Global 250 in 1993 and the Global 250 in 2017.

[46] KPMG, The KPMG Survey of CR Reporting 2017, at 11, available *at* https://home.kpmg.com/content/dam/kpmg/campaigns/csr/pdf/CSR_Reporting_2017.pdf.

[47] *Id.*

[48] *See id.* at 28. The Global Reporting Initiative is now in its fourth iteration. It has been developed by, and is used by, thousands of companies, governments, and non-profit entities around the world to report on the economic, environmental, social and governance effects of entities' actions. *See* Global Reporting Initiative, *available at* http://www.globalreporting.org.

[49] *See* KPMG 2017 Report, *supra* note 42, at 26.

[50] Klaus Dingwerth & Margot Eichinger, *Tamed Transparency: How Information Disclosure under the Global Reporting Initiative fails to Empower*, 10:3 GLOBAL ENV. POL. 74, 88 (2010).

[51] Markus J. Milne, Amanda Ball & Rob Gray, *Wither Ecology? The Triple Bottom Line, the Global Reporting Initiative, and the Institutionalization of Corporate Sustainability Reporting*, 188 (1) J. BUS. ETHICS 1 (2013).

being reported.[52] These conclusions should not be taken as a criticism of GRI *per se*, or of companies' efforts to provide expanded ESG information. Rather, these conclusions are an indication of the weaknesses of voluntary disclosure: without a regulatory mandate, the information being produced is often incomplete, lacks consistency, and is not comparable between companies. In contrast, when ESG disclosure becomes mandatory, standards become clearer and reporting becomes more consistent and comparable.[53] In analogous circumstances, the SEC has recognized the importance of standardized disclosure frameworks for financial information, expressing concerns about the use of non-GAAP accounting, concluding that information being disclosed without adherence to the standardized disclosure framework of U.S. GAAP may be confusing and even deceptive.[54]

4. *Companies' Voluntary Disclosure is Insufficient to Meet Investors' Needs*

Given these problems with the quality of voluntary ESG disclosure, notwithstanding the efforts of public companies to meet investors' needs, a wide range of capital market participants have come out in favor of required ESG disclosure. In response to the Concept Release, the SEC received comments from asset managers, institutional investors, individual investors, foundation executives, and public pension funds, among others. These users of corporate disclosure "overwhelmingly expressed support" for more required ESG disclosure.[55] BlackRock, the world's largest asset manager, with assets under management of $6.317 trillion as of March 31, 2018, has recognized the strategic value of ESG information:

> Environmental, social, and governance issues are integral to our investment stewardship activities, as the majority of our clients are saving for long-term goals. It is over the long-term that ESG factors – ranging from climate change to diversity to board effectiveness – have real and quantifiable financial impacts. Our risk analysis extends across all sectors and geographies, helping us identify companies lagging behind peers on ESG issues.[56]

And yet, BlackRock asserts that current reporting practices are insufficient for the kinds of in-depth investment analysis that it seeks with its ESG integration, making it "difficult to identify investment decision-useful data." As a result, it has advocated for public policy

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[52] *See* David Levy, Halina S. Brown, & Martin de Jong, *The Contested Politics of Corporate Governance: The Case of the Global Reporting Initiative*, 49 BUS. & SOC'Y 88 (2010); *see also* Carl-Johan Hedberg & Fredrik von Malmborg, *The Global Reporting Initiative and Corporate Sustainability Reporting in Swedish Companies*, 10 CORP. SOC. RESP. & ENVTL. MGMT. 153 (2003).

[53] *See generally*, Jody Grewal, Edward J. Riedl & George Serafeim, *Market Reactions to Mandatory Nonfinancial Disclosure*, at 27 (Harvard Business School Working Paper, No. 16-025, 2015), http://www.ssrn.com/abstract=2657712 (stating that "firms having high ESG disclosure and stronger governance performance will be able to institute the [EU Directive on non-financial reporting] more efficiently and cost-effectively" because the reporting is mandatory, thus creating consistency).

[54] *See* Chair Mary Jo White, *Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility,"* Dec. 9, 2015, *available at* http://www.sec.gov/news/speech/keynote-2015-aicpa-white.html; U.S. Securities and Exchange Commission, *Non-GAAP Financial Measures*, Oct. 17, 2017, *available at* https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[55] Gellasch Joint Report, *supra* note 2, at 17.

[56] *See* BlackRock, *Viewpoint, Exploring ESG: A Practitioners Perspective* (June 2016), *available at* http://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-exploring-esg-a-practitioners-perspective-june-2016.pdf.

changes to require companies to disclose such information, assuming appropriate safe harbors are also provided.[57]

BlackRock is not alone among substantial asset owners and asset managers advocating for better ESG disclosure in required securities filings. As discussed in Section Four, below, the Human Capital Management Coalition, a group of 25 institutional investors representing $2.8 trillion in assets, has submitted a rulemaking petition to the Commission urging the adoption of standards that would require listed companies to disclose information on human capital management policies, practices, and performance.[58] In July 2017, 390 investors representing more than $22 trillion in assets wrote to G20 heads of state, calling on governments to "evolve the financial frameworks required to improve the availability, reliability and comparability of climate-related information."[59]

Bloomberg, another global company that sells capital markets data, has reached conclusions similar to those of BlackRock about the quality of ESG data. Since 2009, Bloomberg has incorporated ESG data into the data that it sells to dealers, brokers, and investors around the world.[60] Even so, its CEO Michael Bloomberg has said this:

> [F]or the most part, the sustainability information that is disclosed by corporations today is not useful for investors or other decision-makers. . . .To help address this issue, I became chair of the Sustainability Accounting Standards Board (SASB) in 2014, and last year [2015], I agreed to build on that work by chairing the new Task Force on Climate-Related Financial Disclosures (TCFD)….The market cannot accurately value companies, and investors cannot efficiently allocate capital, without comparable, reliable and useful data on increasingly relevant climate-related issues….[61]

The Task Force on Climate-Related Financial Disclosure (TCFD) was constituted by the Financial Stability Board, under the auspices of the G20.[62] It has now released its final recommendations for a framework of climate-relevant financial disclosure, focusing on four aspects of a company's operations in respect of climate change: Governance, Strategy, Risk Management, and Metrics & Targets.[63] Among what the TCFD calls its "key recommendations" is that climate-related financial disclosures should be included in required financial filings, thus that this type of reporting should be mandatory.[64]

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[57] *Id.* at 1.

[58] http://uawtrust.org/hcmc.

[59] https://www.ceres.org/news-center/press-releases/over-200-global-investors-urge-g7-stand-paris-agreement-and-drive-its.

[60] *See* Bloomberg, *Impact Report Update 2015* 2, (2015), *available at* http://www.bbhub.io/sustainability/sites/6/2016/04/16_0404_Impact_report.pdf.

[61] *Id.*

[62] The Task Force, chaired by Michael R. Bloomberg, was established by the FSB in December 2015 pursuant to a request from Bank of England Governor Mark Carney "to develop a set of voluntary disclosure recommendations for use by companies in providing information to investors, lenders and insurance underwriters about their climate-related financial risks." *See* https://www.fsb-tcfd.org/news/#.

[63] *See* Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017, at iii, *available at* https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf [hereinafter "Task Force Report"].

[64] *Id.*

Notwithstanding the problems with the quality of voluntarily produced ESG information in the markets, the substantial growth in voluntary sustainability disclosure globally is important for a number of reasons. First, companies are responding to investors who are increasingly aware of the relevance of ESG data to a full evaluation of company strategies, risks, and opportunities. This investor awareness shows the materiality of this information, particularly to shareholders with a long-term orientation. Second, to produce sustainability reports companies have developed internal procedures to collect and evaluate the kinds of information that an SEC framework would likely require, thus showing that costs to companies should not be an impediment. While not all companies have embarked on sustainability reporting, therefore adoption will include some additional costs to some companies, the SEC is well-positioned to provide "on-ramps" or differentiated requirements for smaller companies, as it has done historically. Third, and perhaps most important, twenty-five years of development of voluntary sustainability disclosure has not led to the production of consistent, comparable, highly-reliable ESG information in the market, notwithstanding the voluntary, multi-stakeholder development of a framework for disclosure (GRI) that is being used by 75% of the world's largest companies. SEC leadership providing a mandate for ESG disclosure in the world's largest, and arguably most important, capital market can significantly contribute to solving this problem.

5. ***Commission rulemaking will reduce the current burden on public companies and provide a level playing field for the many American companies engaging in voluntary ESG disclosure***

In addition to benefiting investors, rulemaking regarding ESG disclosure would benefit America's public companies by providing clarity to them about what, when and how to disclose material sustainability information. Today companies are burdened with meeting a range of investor expectations for sustainability information without clear standards about how to do so. A number of promising frameworks have been promulgated over the previous decade or decades, many of which have been mentioned in this petition: GRI, SASB, CDP, and now TCFD being the most prominent. And yet, because there isn't clear guidance and an authoritative standard in the U. S. for all public reporting companies to use, different companies are using different frameworks and multiple mechanisms to disclose sustainability information. Thus, investors are still dissatisfied with the comparability of sustainability information, even between companies in the same industry.[65]

That ESG disclosure requirements could actually reduce burdens on America's public companies was well-stated in the CFA Institute's Comment Letter to the Concept Release:

> Many issuers already provide lengthy sustainability or ESG reports to their investors, so many issuers will not face a new and burdensome cost by collecting, verifying and disclosing ESG information. Costs may be saved if instead of producing large sustainability reports that cover a broad range of sustainability information, issuers can instead focus on only collecting, verifying and disclosing information concerning the factors that are material to them and their investors.[66]

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[65] *See* PwC, *Sustainability Disclosures: Is your company meeting investor expectations?* (July 2015), *cited in* Jean Rogers, SASB Comment Letter to the SEC's April, 2016 Concept Release, July 1, 2016, at 7 fn.20 (79% of investors polled said they were dissatisfied with the comparability of sustainability information between companies).

[66] CFA Institute Comment Letter to the Concept Release, October 6, 2016, at 19. The CFA Institute is a global, not-for-profit professional association of over 137,000 investment analysts, advisers, portfolio managers, and other

Such rulemaking would also act to create a level playing field between companies. Today, sustainability information is being provided by some but not all companies, in formats that differ, using different mechanisms for disclosure (sustainability reports, company websites, SEC filings), and different timing. As recognized in an analysis of sustainability reporting by PwC in 2016, this has created a situation where information is not comparable between companies in the same industry and sector; where "an increasing volume of information is being provided without linkage to a company's core strategy," and where there are no clear standards all companies within the same industry are using.[67] Such standards could well encompass a mix of required elements, based on industry and sector; information about firms' governance of sustainability issues across industries; and principles-based elements to act as a materiality back-stop. By providing clarity to issuers on what sustainability disclosure is required, the SEC would create comparability between firms in the same industry, thus promoting a level playing field between companies. Comparability will allow actual sustainability leaders to be recognized as such, with attendant financial benefits such as increased investment and a lower cost of capital.[68]

6. Various ESG-related Petitions and Stakeholder Engagements with the SEC Suggest, in Aggregate, that it is Time for the SEC to Act to Bring Coherence to this Area

In recent years, there have been a number of significant petitions and other investor proposals seeking expanded disclosure of ESG information. These initiatives give evidence of the views of investors and capital markets professionals that more needs to be done to meet investors' needs for consistent, comparable, and high-quality ESG data. Moreover, stakeholders have used additional opportunities created by the SEC to support for broader ESG disclosure. A sampling of such petitions, investor proposals, and stakeholder engagements includes:

Climate Risk Disclosure: In 2007 and 2009, Ceres filed petitions to the SEC calling for better guidance to companies on how to disclose risks and opportunities from climate change. In 2010, the SEC responded by issuing such guidance.[69] Analysis indicates that the guidance has not been successful in producing consistent, comparable, high-quality information concerning climate change risks and opportunities, however.[70] The Framework and Technical Guidance published

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investment professionals in more than 157 countries. On the question of the SEC requiring sustainability disclosure, the CFA Institute concluded that "[i]t is imperative that the SEC develop disclosure requirements that require companies to disclose material sustainability information while allowing issuers the flexibility to disclose that which is germane to their industry/sector . . . " Thus the Institute supported differentiated sustainability disclosure according to industry and sector, along with a general requirement for companies to disclose the corporate governance arrangements for sustainability issues. *Id.*

[67] PwC, *Point of View: Sustainability reporting and disclosure: What does the future look like? (July 2016),* at 1, *available at* . https://www.pwc.com/us/en/cfodirect/publications/point-of-view/sustainability-reporting-disclosure-transparency-future.html.

[68] *See, e.g.,* Clark et al., *supra* note 29 (summarizing empirical literature through 2015, and finding that 90% of studies show lowered cost of capital for firms with sound sustainability practices; 88% of studies show that better E,S, or G practices (the latter specific to sustainability) result in better operational performance; and 80% of studies show stock market out-performance for firms with good sustainability practices.

[69] Commission Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106; 34-61469; FR-82, Feb. 8, 2010, U.S. SECURITIES AND EXCHANGE COMMISSION, *available at* https://www.sec.gov/rules/interp/2010/33-9106.pdf.

[70] *See, e.g.,* Robert Repetto, *It's Time the SEC Enforced Its Climate Disclosure Rules*, INTERNATIONAL INSTITUTE FOR SUSTAINABLE DEVELOPMENT (IISD)(Mar. 23, 2016), *available at* https://www.iisd.org/blog/it-s-time-sec-enforced-its-climate-disclosure-rules.

by the FSB's Task Force on Climate-Related Financial Disclosure (TCFD), mentioned above, would be an industry-developed (operating companies, investors, insurance companies, and accounting) platform for the SEC to use as a starting point in promulgating its own Framework for comprehensive ESG disclosure.

ESG Disclosure: On July 21, 2009, the U.S. Social Investment Forum (USSIF) requested that the SEC promulgate a new, annual requirement for ESG disclosure, modeled on the framework of the Global Reporting Initiative (GRI). GRI sets out a general framework for disclosure of information applicable to all companies, and then industry-specific requirements relevant to the social, environmental, and governance concerns applicable to each specific industry. The USSIF petition also asked the SEC to issue interpretive guidance to clarify that companies are required to disclose short and long-term sustainability risks in the Management Discussion and Analysis section of their 10-K.

Gender pay ratios: On February 1, 2016, Pax Ellevate Management LLC, investment adviser to the Pax Ellevate Global Women's Index Fund submitted a petition to the Commission requesting that it require public companies to disclose gender pay ratios on an annual basis. Petitioners stated that "[w]e believe that pay equity is a useful and material indicator of well-managed, well-governed companies, and conversely, that companies exhibiting significant gender pay disparities may bear disproportionate risk, and that investors therefore may benefit from having such information."[71]

Human Capital Management: On July 6, 2017, the Human Capital Management Coalition, a group of institutional investors with $2.8 trillion in assets, submitted a petition to the Commission requesting that it "adopt new rules, or amend existing rules, to require issuers to disclose information about their human capital management policies, practices and performance."[72] The Coalition seeks this expanded disclosure so that "(1) investors can adequately assess a company's business, risks and prospects; (2) investors can more "efficiently direct capital to its highest value use, thus lowering the cost of capital for well-managed companies; (3) companies can stop responding to a myriad of voluntary questionnaires seeking this information; and (4) investors can pursue long-term investing strategies in order "to stabilize and improve our markets and to effect the efficient allocation of capital."

Human Rights: The human rights policies, practices, and impacts of filers are material to many investors.[73] The SEC has already provided for some human rights disclosure regarding conflict minerals under 17 CFR §240.13p-1, in response to the Dodd-Frank Act, and in certain guidance on disclosure relating to climate change[74] and cyber-security information.[75] General guidance on disclosure of human rights policies, practices, and impacts is lacking, however.

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[71] *See* Pax Ellevate Petition, February 1, 2016, *available at* https://www.sec.gov/rules/petitions/2016/petn4-696.pdf.
[72] *See* Human Capital Management Coalition Petition, July 6, 2017, available *at* https://www.sec.gov/rules/petitions/2017/petn4-711.pdf.
[73] *See, e.g.,* CYNTHIA WILLIAMS ET AL., "KNOWING AND SHOWING" USING U.S. SECURITIES LAWS TO COMPEL HUMAN RIGHTS DISCLOSURE (Oct. 2013) at 16, *available at* http://icar.ngo/wp-content/uploads/2013/10/ICAR-Knowing-and-Showing-Report4.pdf.
[74] Securities & Exchange Comm'n, Commission Guidance Regarding Disclosure Related to Climate Change (Jan. 27, 2010), Release Nos. 33-9106; 34-61469; FR-82, http://www.sec.gov/rules/interp/2010/33-9106.pdf [hereinafter Climate Change Guidance (2010)].
[75] Securities & Exchange Comm'n, Division of Corporate Finance, CF Disclosure Guidance: Topic No. 2 Cybersecurity (2011), http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm [hereinafter Cyber-

In responding to the 2016 Concept Release, a number of stakeholders provided comments on the value of increased disclosure about a number of human rights issues. These comments highlighted the need for better information about the impacts of companies on the human rights of affected communities, but also discussed human rights impacts related to the environment, climate change, human capital, and workforce issues. Over 10,000 commenters raised issues within these different substantive areas.[76] Additionally, in relation to Conflict Minerals rule, when Acting Chairman Piwowar announced the SEC's reconsideration of the rule's implementation in January 2017, the Commission received over 11,500 comments in support of the rule—demonstrating strong stakeholder interest in its continued use.[77]

Political Spending Disclosure: On August 3, 2011, the Committee on Disclosure of Corporate Political Spending (ten academics at leading law schools whose teaching and research focus on corporate and securities law), petitioned the Commission to develop rules to require public companies to "disclose to shareholders the use of corporate resources for political activities."[78] Recognizing that the U.S. Supreme Court in *Citizens United v. FEC,* 130 S. Ct. 876 (2010), noted shareholder mechanisms to hold management to account for its use of corporate funds to support political candidates, the petitioners argued that for that mechanism to work, "shareholders must have information about the company's political speech."[79] To date, this petition has garnered more than 1.2 million comments of support, the most in the agency's history.[80]

Tax Disclosure: In its April 2016 Concept Release the SEC asked about what, if anything, should be changed, updated, included or removed regarding tax disclosure. The Comment Letter submitted by the Financial Accountability and Corporate Transparency (FACT) Coalition emphasized that the role played by international tax strategies and rates on the operations and earnings of many U.S. corporations is important and growing. The letter highlighted the risks to investors created by these at best uncertain and often legally problematic strategies. Given the scope of fines and risks arising from tax jurisdictions around the world, investors need more information to be able to evaluate the scope of tax risks tht the company is running. Moreover, the new tax law in the U.S. moves the U.S. to a territorial tax system, which will open up further uncertainties and risks related to how and where revenues are booked.

The IRS recently finalized a rule to require country-by-country reporting of revenues, profits, taxes paid and certain operations by larger multinational corporations. The European Union has also established new country-by-country reporting requirements for larger firms doing business in any of the member nations. Increasingly, tax authorities have access to this material information, as do company managers, yet investors do not. The growing use of offshore tax

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Security Guidance].

[76] Gellasch Joint Report, *supra* note 2, at 10.

[77] *Comments on the Statement on the Commission's Conflict Minerals Rule,* U.S. SECURITIES AND EXCHANGE COMMISSION, *available at* https://www.sec.gov/comments/statement-013117/statement013117.htm (last visited Jan. 25, 2018).

[78] *See* Committee on Disclosure of Corporate Political Spending Petition, August 3, 2011, *available at* https://www.sec.gov/rules/petitions/2011/petn4-637.pdf.

[79] *Id.* at 7.

[80] *See* Comments on Petition to Require Public Companies to Disclose to Shareholders the Use of Corporate Resources for Political Activities, *available at* https://www.sec.gov/rules/petitions/2017/petn4-711.pdf (viewed November 20, 2017),

strategies, the international response to rein in aggressive tax avoidance, and the potential tax liability for corporations engaged in these practices makes this information material for investors.

These petitions, in conjunction with the large numbers of comments in support of expanded sustainability disclosure in response to the SEC's Concept Release, clearly show that investors and capital market professionals think the time has come for the SEC to act to develop a mandatory rule for clearer, consistent, comparable, high-quality ESG disclosure by all companies subject to SEC public-reporting requirements.

Conclusion

We respectfully request the Commission to promptly initiate rulemaking to develop mandatory rules for public companies to disclose high-quality, comparable, decision-useful environmental, social, and governance information. If the Commission or Staff have any questions, or if we can be of assistance in any way, please contact either **Osler Chair in Business Law Cynthia A. Williams**, Osgoode Hall Law School, who can be reached at (416) 736-5545, or by electronic mail at cwilliams@osgoode.yorku.ca; or **Saul A. Fox Distinguished Professor of Business Law Jill E. Fisch**, University of Pennsylvania Law School, who can be reached at (215) 746-3454, or by electronic mail at jfisch@law.upenn.edu.

Sincerely,

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