Public Statement

“Modernizing” Regulation S-K: Ignoring the Elephant in the Room

Commissioner Allison Herren Lee

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Today’s proposal is most notable for what it does not do: make any attempt to address investors’ need for standardized disclosure on climate change risk. The Commission last addressed climate change disclosure in 2010.[1] In that guidance we identified four existing items in Regulation S-K that may require disclosure related to climate change: description of business, legal proceedings, risk factors, and management’s discussion and analysis of financial condition and results of operations, or MD&A. We have now proposed to “modernize” every one of these four items without mentioning climate change or even asking a single question about its relevance to these disclosures.[2]

Much has changed in the last decade with respect to what we know about climate change and the financial risks it creates for global markets. The science is largely undisputed and the effects increasingly visible and dire;[3] the looming economic threat to markets worldwide is more and more apparent;[4] investors have increased their demands on companies and regulators for consistent, reliable, and comparable disclosures,[5] and more companies understand these risks and have responded;[6] voluntary reporting standards have proliferated;[7] major legislation has been introduced,[8] and regulators around the globe are taking action.[9]

Perhaps most importantly in terms of SEC attention, investors are overwhelmingly telling us, through comment letters and petitions for rulemaking, that they need consistent, reliable, and comparable disclosures of the risks and opportunities related to sustainability measures, particularly climate risk.[10] Investors have been clear that this information is material to their decision-making process, and a growing body of research confirms that.[11] And MD&A is uniquely suited to disclosures related to climate risk; it provides a lens through which investors can assess the perspective of the stewards of their investment capital on this complex and critical issue.

It is also clear that the broad, principles-based “materiality” standard has not produced sufficient disclosure to ensure that investors are getting the information they need—that is, disclosures that are consistent, reliable, and comparable. What’s more, the agency’s routine disclosure review process could be used to improve disclosure under the materiality standard, but in recent years there’s been minimal comment on climate disclosure.[12] Indeed, investors and shareholders have undertaken an arguably unprecedented and massive campaign to obtain climate-related disclosure from issuers.[13] As a result, most large public companies now provide some sustainability disclosure, including in reports separate and apart from the SEC’s required disclosure regime, that provide some of the information sought by investors.[14] But these voluntary disclosures, while a welcome development, are no substitute for Commission action for a number of reasons.

First, without a mandatory standardized framework, not all issuers will disclose, and disclosure will continue to vary greatly by issuer, making it difficult if not impossible for investors to compare companies.[15]

Second, the proliferation of voluntary standards and principles—and specific requests from numerous investors—put significant and sometimes competing demands on issuers, creating workstreams and costs that could be simplified and mitigated by uniform standards.[16]

Third, significant questions exist regarding the reliability of the information disclosed in these reports. Such disclosures may lack sufficient third party verification,[17] and also may leave investors with inadequate remedies for inaccurate and incomplete disclosures.[18]

What is the right regulatory approach to this issue? How much disclosure is needed and where should it be made? Are there particular metrics that should be required? What's the right balance between line-item and principles-based disclosure? How should disclosures accommodate sector-specific reporting? How and to what extent could we leverage existing voluntary frameworks?

These are important and challenging questions to address. But we have not engaged in that discussion at all even as we update the very provisions that we've said may implicate climate change disclosure. We purport to modernize, without mentioning what may be the single most momentous risk to face markets since the financial crisis. Where we should be showing leadership, we are conspicuously silent.[19] In so doing, we risk falling behind international efforts and putting US companies at a competitive disadvantage globally.

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In addition to my overarching concern regarding climate risk disclosures, I note that today's proposal would eliminate significant disclosure items,[20] while laudably enhancing others.[21] And, as with our last Regulation S-K proposal, today's proposal heavily favors a principles-based approach rather than balancing the use of principles with line-item disclosure.[22] I continue to be concerned that the increased flexibility and discretion that this approach affords company executives may result in significant costs to investors—both if materiality is misapplied and through the loss of important comparability in disclosure.[23] I hope we will receive robust comment on these issues, as well as on climate risk disclosures.

Finally, as always, it is quite clear to me that our staff has done thoughtful and diligent work in putting together today's proposals. I'm grateful for their continued dedication, and respectful of their deep expertise and experience.[24] My objection is to the policy choice we make as a Commission to ignore the challenge of disclosure around climate change risk rather than to begin the difficult process of confronting it. As a result, I cannot support the proposal.

I am, however, pleased to see Chairman Clayton discussing his views on climate-related disclosure in his statement today. I am hopeful we can work together on this issue going forward.

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[1] *See* Commission Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106 (Feb. 8, 2010).

[2] Both our August proposal on Regulation S-K and today's proposal include a reference to the 2010 climate guidance, but only to provide an example of the flexibility afforded by a principles-based approach to disclosure. *See* Securities and Exchange Commission, Modernization of Regulation S-K Items 101, 103, and 105, Rel. No. 33-10668, n.11 (Aug. 8, 2019); Securities and Exchange Commission, Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information, Rel. No. 33-10750, n.95 (Jan. 30, 2020). In addition, in today's MD&A guidance, we simply refer to the fact that some companies currently voluntarily disclose environmental metrics, and we

mention “total energy consumed” among a long list of voluntary metrics to which the guidance is intended to apply. *See* Commission Guidance on Management’s Discussion and Analysis of Financial Condition and Results of Operations, Rel. No. 10751 (Jan. 30, 2020). These passing references, however, are clearly not intended, nor are they sufficient, to start a discussion regarding appropriate disclosure around climate change.

[3] *See* NASA, Scientific Consensus: Earth’s Climate is Warming, https://climate.nasa.gov/scientific-consensus/ (“Multiple studies published in peer-reviewed scientific journals show that 97 percent or more of actively publishing climate scientists agree: Climate-warming trends over the past century are extremely likely due to human activities.”); Intergovernmental Panel on Climate Change, Special Report on Global Warming of 1.5°C (Oct. 2018) (finding global warming is likely to reach 1.5 degrees Celsius between 2030 and 2052 if it continues to increase at the current rate, and discussing climate-related risks to health, livelihoods, food security, water supply, human security, and economic growth); World Meteorological Organization, Statement on the State of Global Climate in 2018 (Mar. 2019) (discussing accelerating physical signs and socio-economic impacts of climate change).

[4] *See* Rostin Benham, Comm’r, U.S. Comm. Fut. Trading Comm’n, Opening Statement Before the Market Risk Advisory Committee (June 12, 2019) (“The impacts of climate change affect every aspect of the American economy—from production agriculture to commercial manufacturing and the financing of every step in each process.”); Matthew E. Kahn et al., Long-Term Macroeconomic Effects of Climate Change: A Cross-Country Analysis, IMF Working Paper No. 19/215 (Oct. 11 2019) (finding that persistent warming will reduce world GDP per capita by more than seven percent by 2100); Willem Buiter & Benjamin Nabarro, Citigroup, Managing the Financial Risks of Climate Change (Oct. 2019) (“Greenhouse gas emissions, global warming, and climate change are not only existential issues for those concerned with the future of humanity, they are also immediate concerns for financial regulators”); U.S. Global Change Research Program, Fourth National Climate Assessment, Rev. June 2019 (“With continued growth in emissions at historic rates, annual losses in some economic sectors are projected to reach hundreds of billions of dollars by the end of the century—more than the current gross domestic product (GDP) of many U.S. states.”); *see also* Russell Gold, *PG&E: The First Climate-Change Bankruptcy, Probably Not the Last*, Wall St. J. (Jan. 18, 2019).

[5] *See* Gabriel T. Rubin, *Show Us Your Climate Risks, Investors Tell Companies*, Wall St. J. (Feb. 28, 2019) (noting that “companies are projected to face a record of 75 or more climate-related shareholder proposals, up from 17 in 2013”); Letter from Cynthia A. Williams and Jill E. Fisch (Oct. 1, 2018) (enclosing a petition for rulemaking to the SEC on standardized disclosure related to environmental, social, and governance (ESG) issues, including climate disclosure, signed by investors and organizations representing more than $5 trillion in assets under management) (Petition for Rulemaking on ESG).

[6] *See* Governance & Accountability Institute, Inc., Flash Report: 86% of S&P 500 Index® Companies Publish Sustainability/Responsibility Reports in 2018 (May 16, 2019) (finding that sustainability reporting by S&P 500 companies has grown from 20% in 2011 to 86% in 2018); *see also* JPMorgan Chase & Co., *Understanding Our Climate-Related Risks and Opportunities* (May 2019) (acknowledging that “[c]limate change is a global challenge that has presented—and will continue to present—risks for businesses and communities around the world”); Alphabet, Inc., Form 10-K (2018) (“We believe that climate change is one of the most significant global challenges of our time. . . Google’s approach to climate change and our broader sustainability efforts are provided in our annual sustainability reports.”).

[7] *See, e.g.*, Task Force on Climate-Related Financial Disclosures, https://www.fsb-tcfd.org/tcfd-supporters; (supported by over 930 organizations representing a market capitalization of over $11 trillion); United Nations Principles for Responsible Investment, https://www.unpri.org/download?ac=6303 (more than 2,000 signatories from over 60 countries representing over $80 trillion of assets); Global Reporting Initiative, https://www.globalreporting.org/information/sustainability-reporting/Pages/gri-standards.aspx (over 23,000 reports recorded in GRI’s database).

[8] *See, e.g.*, Climate Disclosure Act of 2019, H.R.3623, 116th Cong. (2019-2020); Climate Change Financial Risk Act of 2019, S.2903, 116th Cong. (2019-2020).

[9] *See, e.g.,* Bank of England, The 2021 biennial exploratory scenario on the financial risks from climate change (Dec. 18, 2019) (a discussion paper inviting banks and insurers to test their exposure to climate-related risks); European Commission, Capital Markets Union: Commission welcomes agreement on sustainable investment disclosure rules (March 7, 2019) (announcement of political agreement on uniform ESG disclosure requirements); *see also* Network for Greening the Financial System, *A call for action: Climate change as a source of financial risk* (Apr. 2019) (recognition by a network of, at the time of the report, 34 central banks and financial supervisors, that "[c]limate-related risks are a source of financial risk and it therefore falls squarely within the mandates of central banks and supervisors to ensure the financial system is resilient to these risks.").

[10] *See* Sustainability Accounting Standards Board, The State of Disclosure (2016) (analyzing comment letters submitted in response to the Regulation S-K Concept Release and find that "[d]espite the fact that sustainability disclosure was a relatively minor topic of discussion in the SEC release (covering about four of its 92 pages), two-thirds of the more than 276 non-form comment letters the Commission received in response addressed sustainability-related concerns" and over 80% of those letters called for improved information in SEC filings, with only 10% opposing SEC action on this subject.); *see also* Petition for Rulemaking on ESG, supra note 5.

[11] *See* Emirhan Ilhan et al., *Institutional Investors' Views and Preferences on Climate Risk Disclosure*, Swiss Finance Institute Research Paper Series N. 19-66, (last revised Jan. 7, 2020) ("We find that the survey respondents share a strong general belief that climate disclosure is important. In fact, 51% of respondents believe that climate risk reporting is as important as traditional financial reporting, and almost one-third considers it to be more important."); Mozaffar Khan et al., *Corporate Sustainability: First Evidence on Materiality*, 91 The Acctng. Rev. 1697 (2018) ("Using both calendar-time portfolio stock return regressions and firm-level panel regressions we find that firms with good ratings on material sustainability issues significantly outperform firms with poor ratings on these issues.").

[12] *See* Mindy Lubber, CEO and President of Ceres, Comments on the Climate Risk Disclosure Act of 2019 (July 18, 2019) ("A search for SEC comment letters asking issuers to improve their climate-related disclosure in Commission filings reveals only one such letter from January 2017 to [July 2019].").

[13] *See e.g.*, Climate Action 100+, an investor initiative with 375 signatories representing over $35 trillion in assets under management seeking improved climate performance and transparent disclosure from the world's largest greenhouse gas emitters. *See also* State Street Global Advisors, The ESG Data Challenge (Mar. 2019) ("Asset owners and their investment managers seek solutions to the challenges posed by a lack of consistent, comparable, and material information. Investors increasingly view material ESG factors as being critical drivers of a company's ability to generate sustainable long-term performance. In turn, ESG data has increasing importance for investors' ability to allocate capital most effectively."); Letter from Larry Fink, Chairman & CEO, BlackRock to CEOs (Jan. 14, 2020) ("Investors are increasingly reckoning with these questions and recognizing that climate risk is investment risk. Indeed, climate change is almost invariably the top issue that clients around the world raise with BlackRock . . . They are seeking to understand both the physical risks associated with climate change as well as the ways that climate policy will impact prices, costs, and demand across the entire economy. These questions are driving a profound reassessment of risk and asset values."). I also note record high levels of shareholder engagement on this topic. *See* Maximilian Horster and Kosmas Papadopoulos, *Climate Change and Proxy Voting in the U.S. and Europe* (Jan. 7, 2019).

[14] *See* Governance and Accountability Institute, Inc., supra note 6 (noting 86 percent of S&P 500 companies published sustainability reports in 2018).

[15] *See* Christine Robinson et al., Deloitte & Touche LLP, *#DeloitteESGnow - Sustainability Disclosure Goes Mainstream* (Sept. 24, 2019) (noting that investors increasingly rely on ESG disclosure but "remain

dissatisfied with the current state of this content"); *see also* Sara Bernow et al., McKinsey & Company, *More than values: The value-based sustainability reporting that investors want* (Aug. 2019) (finding that "investors say they cannot readily use companies' sustainability disclosures to inform investment decisions and advice accurately"); Task Force on Climate-Related Financial Disclosures, Phase I Report of the Task Force on Climate-Related Financial Disclosures (2016) ("[U]sers of climate-related financial disclosure commonly identify inconsistencies in disclosure practices, a lack of context for information, and uncomparable reporting as major obstacles to incorporating climate-related risks as a consideration in the investment, credit, and underwriting decisions over the medium and long term.").

[16] I note with significant interest a recent survey conducted by McKinsey & Company of 107 executives and investors, representing 50 companies, 27 asset managers, and 30 asset owners in Asia, Europe, and the United States. The survey indicates that investors and company executives alike support a legal mandate requiring sustainability reporting. *See* Bernow et al., supra note 14.

[17] *See* Robinson et al., supra note 14 (noting the "lack of standardized investor-grade information" in sustainability disclosures); Bernow et al., supra note 14 (noting 97% of investors surveyed wanted some form of audit for sustainability disclosures).

[18] *See* Tom Riesenberg and Alan Beller, Sustainability Accounting Standards Board, *Sustainability Accounting Standards and SEC Filings* (June 5, 2019) (discussing varying liability frameworks depending on the location of disclosure).

[19] In the 2016 Regulation S-K Concept Release, the Commission promisingly asked questions about sustainability reporting. *See* Securities and Exchange Commission, Business and Financial Disclosure Required by Regulation S-K, Rel. No. 33-10064 (Apr. 13, 2016). But we have failed in subsequent Regulation S-K proposals, including today, to address the significant public comment on this subject. Compare this to the more active role the CFTC is taking. *See* CFTC Commissioner Behnam Announces the Establishment of the Market Risk Advisory Committee's Climate-Related Market Risk Subcommittee and Seeks Nominations for Membership, Release No. 7963-19 (July 10, 2019). I was, however, pleased to see that the staff is considering holding a roundtable on climate risk, and hope that we follow through with this discussion. *See* Andrew Ramonas, *SEC Mulling Pilot to Give Gig Workers Equity, Official Says*, Bloomberg Law (Jan. 28, 2020) (noting the staff is considering holding a roundtable discussion on climate change disclosures).

[20] Specifically we propose to eliminate Item 301(Selected Financial Data), Item 302 (Supplementary Financial Information), Item 303(a)(4) (MD&A, Off-balance sheet arrangements), and Item 303(a)(5) (MD&A, Tabular disclosure of contractual obligations).

[21] For example, we propose to enhance the capital resources discussion under Item 303(a)(2) and to require disclosure of critical accounting estimates under Item 303(a). In addition, I appreciate that today's MD&A guidance makes an effort to ensure that, when companies choose to disclose metrics, they do so in a way that is not misleading.

[22] For example, we propose to eliminate the current off-balance sheet disclosure required in Item 303(a)(4) in favor of a mere instruction in order "to promote the principles-based nature of MD&A." I am concerned that the elimination of this item, along with the elimination of the tabular presentation of contractual obligations, will result in the loss of comparability for investors that we specifically sought when we adopted the off-balance sheet disclosure mandated by Sarbanes-Oxley. *See* Securities and Exchange Commission, Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Release No. 33-8182 (Jan. 28, 2003) (noting that the separate presentation of off-balance sheet arrangements and the tabular presentation of contractual obligations will enable investors to more easily compare disclosure from different companies).

[23] *See* Joint Statement of Commissioners Robert J. Jackson, Jr. and Allison Herren Lee on Proposed Changes to Regulation S-K (Aug. 27, 2019) (identifying risks associated with principles-based disclosure

including that it gives management discretion over what it tells investors and that it can create inconsistent disclosure that investors cannot easily compare).

[24] In particular, I would like to thank Bill Hinman, Betsy Murphy, Luna Bloom, Courtney Lindsay, Angie Kim, Ryan Milne, Lisa Kohl, Lindsay McCord, Pat Gilmore, Kyle Moffatt, Ellie Quarles, Michael Coco, Kathy Hsu, Arthur Sandel, Lulu Cheng, and Ted Yu in the Division of Corporation Finance; S.P. Kothari, Narahari Phatak, Vladimir Ivanov, Qiao Kapadia, and Mengxin Zhao in the Division of Economic and Risk Analysis; Bryant Morris, Shehzad Niazi, and Evan Jacobson in the Office of the General Counsel; Giles Cohen, Jonathan Wiggins, Peggy Kim, Jonathan Duersch, and Kevin Cherrstrom in the Office of the Chief Accountant; Sarah ten Siethoff, Brian Johnson, and Mark Uyeda in the Division of Investment Management.