Joint Statement of Commissioners Robert J. Jackson, Jr. and Allison Herren Lee on Proposed Changes to Regulation S-K

Commissioner Robert J. Jackson Jr.

Commissioner Allison Herren Lee

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We support sending out for public comment the recently proposed revisions to Regulation S-K, the central repository for non-financial statement disclosure. We're especially grateful to our colleagues in the Division of Corporation Finance, Director Bill Hinman, Betsy Murphy, Felicia Kung, Lisa Kohl, Elliott Staffin, Sandra Hunter Berkheimer, and Shehzad Niazi for their careful and diligent work on this proposal.

We want to start by noting that the proposal is commendable for adding disclosure on the critical topic of human capital. This reflects an understanding of what American families have known for generations: companies that invest in their workers perform better over time.[1]

We write to encourage comment in two critical areas where we believe the proposal should be improved. Specifically, we are concerned about the shift toward a principles-based approach to disclosure and the absence of the topic of climate risk. We urge commenters to come forward to help ensure that our rules produce the comparability and transparency that American investors deserve.

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The proposal favors a principles-based approach to disclosure rather than balancing the use of principles with line-item disclosures as investors—the consumers of this information—have advocated.[2] The flexibility offered by principles-based disclosure makes sense in some cases, but the benefits of that flexibility should be carefully weighed against its costs.

One concern with principles-based disclosure is that it gives company executives discretion over what they tell investors.[3] Another is that it can produce inconsistent information that investors cannot easily compare, making investment analysis—and, thus, capital—more expensive.[4] Our concern is that the proposal's principles-based approach will fail to give American investors the information they need about the companies they own.

For example, the proposal takes a crucial step forward for investors who have long asked for transparency about whether and how public companies invest in the American workforce.[5] But, because it favors flexibility

over bright-line rules, the proposal may give management too much discretion—sacrificing important comparability—when describing a company's investments in its workers.

That's why investors representing trillions of dollars, and our Investor Advisory Committee, have urged the SEC to require specific, detailed disclosures reflecting the importance of human capital management to the bottom line.[6] We hope that commenters will make sure we get this balance right by letting us know what, if any, specific measures would be useful for investors.[7]

Additionally, the proposal does not seek comment on whether to include the topic of climate risk in the Description of Business under Item 101. Estimates of the scale of that risk vary,[8] but what is clear is that investors of all kinds view the risk as an important factor in their decision-making process.[9] Yet it remains tough for investors to obtain useful climate-related disclosure.[10] One argument against mandating such disclosure is that climate risk is too difficult to quantify with acceptable accuracy. Whatever one thinks about disclosure of climate risk, research shows that we are long past the point of being unable to meaningfully measure a company's sustainability profile.

For example, recent work shows that some sustainability measures reveal material information to the market.[11] Despite early skepticism about the utility of those measures, recent efforts to refine them through engagement with issuers and investors have borne real fruit.[12] We hope commenters will weigh in as to whether and how this topic should be included in a final rule. In addition, to the extent the SEC may consider whether and how additional rules should be updated to provide more transparency on climate risk, we hope commenters will provide data and analysis to help guide that important work.

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We are grateful for the Staff's thoughtful work in preparing this proposal, and we support sending it out for comment. We hope, however, that commenters will help us weigh the degree to which the proposal relies too heavily on principles-based disclosures, and the value of adding disclosure regarding climate risk. We especially hope to hear from investors about what metrics, if any, would be most useful to include in any final rules. Investors are the audience for disclosures—and the ultimate arbiters of what is and is not material—and should be our focus as these rules move forward.[13]

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[1] Aaron Bernstein, *The Materiality of Human Capital to Corporate Financial Performance* (Harv. Law Sch. Labor and Worklife Program Working Paper, Apr. 2015) ("[T]here is sufficient evidence of human capital materiality to financial performance to warrant inclusion in standard investment analysis."); Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, 101 J. Fin. Econ. 621, 638 (2011) (finding that "firms with high levels of employee satisfaction generate superior long-horizon returns, even when controlling for industries, factor risk, or a broad set of observable characteristics").

[2] There is a division of views on this subject between investors—who favor a balanced approach using some line-item disclosure rules—and issuers, who prefer the discretion afforded to them by principles-based disclosure. *Compare* Securities and Exchange Commission, Proposed Rule: Modernization of Regulation S-K, Exch. Act. Rel. No. 86614, n.16 (Aug. 8, 2019) *with id*. at n.17. Moreover, our rules are replete with examples of the combined approach, which have served investors well. *Compare, e.g.*, Securities and Exchange Commission, Rules on Disclosure of Executive Compensation, 17 C.F.R. § 229.402(b)(1)(i-iv) (providing flexibility with respect to discussion of executive compensation plan "objectives") *with id.* § 229.402(c)(2) (requiring clear disclosure of the amounts paid to executives).

[3] *See, e.g.*, Andrew A. Acito, Jeffrey J. Burks & W. Bruce Johnson, *The Materiality of Accounting Errors: Evidence from SEC Comment Letters*, 36 Contemp. Acct. Res. 839, 862 (2019) (studying managers' responses to SEC inquiries about the materiality of accounting errors and finding that managers are inconsistent in their application of materiality analysis); Robert G. Eccles and Tim Youmans, *Materiality in Corporate Governance: The Statement of Significant Audiences and Materiality* (Harv. Bus. Sch. Working Paper 16-203, 2015).

[4] The Commission and our Staff have historically given great weight to that consideration when developing disclosure rules. *See, e.g.*, Securities and Exchange Commission, Proposed Rule: Pay Versus Performance, Exch. Act. Rel. No. 74835 (April 29, 2015) (rejecting a fully principles-based approach because "such flexibility would limit comparability across registrants, making the disclosure less useful to shareholders"); Securities and Exchange Commission, Proposed Rule: Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, Exch. Act. Rel. No. 58960 (Nov. 14, 2008) ("The Commission has long expressed its support for a single set of high-quality global accounting standards as an important means of enhancing [] comparability.").

[5] *See* Letter from Human Capital Management Coalition to Brent J. Fields, Sec'y, U.S. Sec. & Exch. Comm'n (July 6, 2017) (describing the "broad consensus" among investors representing more than $2.8 trillion in assets that "human capital management is important to the bottom line"); Letter from US SIF: The Forum for Sustainable and Responsible Investment to Brent J. Fields, Sec'y, U.S. Sec. & Exch. Comm'n (July 14, 2016) ("Disclosure of the types of workers provides investors with information about any potential workforce and supply chain risks.").

[6] Human Capital Management Coalition, *supra* note 5; Investor Advisory Committee, U.S. Sec. & Exch. Comm'n, Recommendation on Human Capital Management Disclosure (March 28, 2019) ("Human capital is increasingly conceptualized as an investable asset. Modernizing the Commission's framework for corporate reporting generally should reflect those facts, subject to the standard of materiality.").

[7] We appreciate that the proposal includes language suggesting potential disclosure regarding the "attraction, retention, and development of personnel." However, we seek comment on more specific metrics that are important to investors. For example, commenters might consider whether measures of the company's use of independent contractors and temporary workers as opposed to full-time employees would be useful, particularly in light of a recent letter from ten U.S. Senators to Google highlighting the company's disparate treatment of contract and temporary workers—who outnumber its full-time employees—and demanding that Google end its "anti-worker practices." Letter from Sherrod Brown et al., to Sundar Pichai, CEO, Google, LLC (July 25, 2019). Commenters might also consider whether the final rule should retain our current requirement to disclose the number of employees, which research has shown is a valuable data point. *See* Patricia M. Dechow et al., *Predicting Material Accounting Misstatements*, 28 Contemp. Acct. Res. 17, 20 (2011) (studying misstatements by managers and finding that "abnormal reductions in the number of employees" are useful in predicting financial misstatements and "reductions in the number of employees" may be an indicator of declining demand for a firm's product).

[8] *See, e.g.*, CDP, Climate Change Report 2019 (noting that "roughly 5% to 7% of the combined market cap[italization]" of the firms studied there is at risk); *see also* 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.").

[9]*See, e.g.*, Vanguard, Investment Stewardship Annual Report (2017) ("[O]ur position on climate risk is anchored in long-term economic value—not ideology."); Letter from California State Teachers' Retirement System to Brent J. Fields, Sec'y, U.S. Sec. & Exch. Comm'n (July 21, 2016) (noting that the "current voluntary approach to climate risk disclosure is not helpful due to inconsistencies, non-comparability across companies, sectors and industries, and the lack of explicit quantitative financial information," and citing data that "strongly supports the need for internal investment staff and our external managers to consider ESG risks of a portfolio company in its evaluation and allocation of capital"); Letter from Ceres to Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n (July 21, 2016) ("Many investors we work with are concerned that the business plans of oil and gas, electric power, and coal companies pose financial risks in the short and long term because they do not sufficiently factor in the risks and opportunities of a more rapid transition to a low carbon global economy.").

[10] *See, e.g.*, Financial Stability Board, Task Force on Climate-Related Financial Disclosures, Phase I Report of the Task Force on Climate-Related Financial Disclosures 3 (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.").

[11] *See, e.g.*, Mozaffar Khan, George Serafeim & Aaron Yoon, *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."); George Serafeim, *Public Sentiment and the Price of Corporate Sustainability* (Working Paper Oct. 12, 2018) ("An ESG factor going long on firms with superior or increasing sustainability performance and negative sentiment momentum . . . delivers significant positive alpha.").

[12] That is especially true of the work of the Sustainability Accounting Standards Board, which has carefully refined its measures through extensive engagement with investors and issuers alike in order to emphasize metrics most material to investors. *See* Sustainability Accounting Standards Board, Why is Financial Materiality Important? (2019) ("SASB standards focus on financially material issues because our mission is to help businesses around the world report on the sustainability topics that matter most to their investors.").

[13] We note that, while a principles-based regime necessarily defers to *management* regarding the relative importance of information, the materiality standard is defined from the perspective of *investors*, whose views should have heavy weight in determining whether and how specified metrics can be material. *Basic, Inc. v. Levinson*, 485 U.S. 224, 244 (1988) (plurality op.) (defining materiality from the perspective of a "reasonable investor" (citing *TSC Industries, Inc. v. Northway, Inc*. 426 U.S. 438 (1976)).