

## Speech

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# Remarks at the 2022 Cato Summit on Financial Regulation



Commissioner Mark T. Uyeda

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Thank you, Jennifer [Schulp], for the kind introduction. Good morning to everyone here in person and those participating virtually. I appreciate being part of your conference focusing on the rise of environmental, social, and governance (ESG) investing and the future of financial regulation. The conference raises a number of important questions, such as “what is ESG?,” “what role should ESG play in investment decisions?,” and “should ESG be considered in assessing financial stability?”<sup>[1]</sup> As you consider these issues, I wanted to share some thoughts that reflect my individual views as a Commissioner and do not necessarily reflect the views of the full Commission or my fellow Commissioners.

### **I. Sustainability of ESG Investing**

First, let’s discuss ESG and sustainability – but I am not referring to ESG and sustainability as interchangeable terms. Rather, the terms are meant to ask whether ESG investing, in its current form, is itself sustainable. The asset management industry has excelled in recent years in attracting fund flows to ESG-themed investment products.<sup>[2]</sup> Whether these trends can be sustained over the long run is an open question, especially if many ESG funds are essentially plays on over-weighting the technology sector while under-weighting the energy sector.<sup>[3]</sup> Meanwhile, on the corporate disclosure side, it is appropriate to inquire whether a specific E, S, or G factor will remain relevant in the future.

#### **A. Disagreement on what is ESG**

When evaluating whether any activity can be maintained, one should think about whether the long-term benefits outweigh the costs. For instance, the financial impact on enterprise valuations for various factors in the “G” category – such as the use of dual-class stock and classified boards of directors – have been known for a long time.<sup>[4]</sup> However, for ESG as a whole, whether there is a net benefit may be difficult to evaluate because interested persons may not agree on what particular factors constitute ESG, much less on how much weight each factor should be given. For example, the Commission has

a pending stock buyback rulemaking proposal.<sup>[5]</sup> Should that disclosure be considered a “G” factor? Or an “S” factor? Or both? Or neither? Reasonable persons could reach different conclusions.

Not surprisingly, one need look no further than the so-called ESG rating agencies, whose evaluations reflect widespread disagreement. A recent study by professors at the Massachusetts Institute of Technology and the University of Zurich found that the average correlation among six prominent ESG rating agencies to be 54%, compared to 99% among credit rating agencies.<sup>[6]</sup> This study showed that the divergence in ESG ratings was due mostly to how rating agencies measure company data, followed by differences in the attributes assessed, and the weighting of those attributes.<sup>[7]</sup> One should not necessarily view the lack of correlation as a bad thing; to the contrary, it could simply reflect that ESG factors are so individualistic, it is difficult to consistently calibrate ESG on a uniform basis.

### **B. Additional Costs Seem Certain**

Despite these disagreements on what constitutes ESG, one aspect seems certain – there will be increased costs and these costs will be ultimately borne by investors. As an example, one should look at the estimated costs associated with the Commission’s proposed climate-related disclosure. In its March 2022 proposal, the Commission estimated that the total existing external cost burden on companies to register their offerings on Form S-1 and file their annual reports on Form 10-K was a little more than \$2 billion.<sup>[8]</sup> The Commission then estimated that the marginal increase from the proposed climate disclosures alone would nearly triple these costs to over \$6.3 billion.<sup>[9]</sup> These estimates were based on the assumption that the cost for external legal advice was \$400 per hour – an amount that has remained flat since 2006.<sup>[10]</sup> Recently, the SEC adjusted the assumed cost to \$600 per hour – and even this revision may be too low.<sup>[11]</sup> Using this \$600 assumption, the total estimated external costs quadruples to \$8.4 billion.<sup>[12]</sup>

One aspect of costs for ESG that may differ from costs associated with other disclosure rules is the potential difficulty for companies to achieve cost efficiencies or economies of scale in preparing ESG disclosures. In the climate-related disclosure proposal, the SEC assumed that compliance costs may decrease after the first year.<sup>[13]</sup> This assumption may or may not be true. The SEC’s proposal permits the use of reasonable estimates, but in the future, technology may be developed allowing for more precise capture of greenhouse gas (GHG) emissions that may entail additional costs. Furthermore, companies may have costs arising from other ESG obligations.

Today, some persons, including non-investor ESG stakeholders, are focused on climate and GHG emissions. However, in the next few years, that focus could shift to other disclosures, such as water-related metrics or other topics that are not currently contemplated. This ever-changing focus of ESG, combined with a lack of consensus on what constitutes ESG, could make it difficult for companies to decrease compliance costs over time.

### **C. Additional Benefits are Uncertain**

Unlike costs, which can be measured and quantified to some degree, the benefits of ESG investing can be more difficult to quantify. Even where quantifiable, the results are mixed. A study by two Vanguard investment strategists concluded that ESG funds have neither systematically higher nor systematically lower raw returns or risk than the broader market. <sup>[14]</sup> In contrast, a study by a sustainability data firm found that funds weighted towards companies with positive ESG scores outperformed the unweighted benchmark.<sup>[15]</sup> However, focusing on the portfolio consisting of North American companies, the excess returns were only 0.17%. Further, when broken down by E, S, and G categories, portfolios with strong governance metrics outperformed the benchmark by the most, at

0.70%, followed by portfolios with strong environmental metrics at 0.28%. In contrast, portfolios with strong social metrics underperformed the benchmark by 1.29%.

#### **D. Investors Should Assess the Sustainability of ESG Investing**

The uncertainty of benefits associated with ESG investing, combined with the certainty of costs for companies undertaking ESG activities, should motivate all market participants – whether public companies, investors, or asset managers – to question whether the ESG trend itself is sustainable over the long term. But as a starting point, it could be useful to define what exactly is ESG. Otherwise, it is difficult to implement a disclosure regime that is consistent, comparable, and decision-useful when ESG factors and weightings are all in the eye of the beholder.

### **II. Disclosure of Asset Managers' Engagement Efforts**

One aspect of ESG investing, which is employed even with respect to certain non-ESG themed funds, is the idea of stewardship and engagement by asset managers with public companies. Specifically, some asset managers conduct extensive stewardship activities, even when their funds are marketed as “passive” or “index-tracking” investments. Companies often engage with these asset managers because of the influence and leverage that asset managers can have, as the funds advised by the asset managers hold the companies' voting securities. In the SEC regulatory regime, these asset managers are said to have “beneficial ownership” of companies' voting securities because they have the power to vote, or to direct the voting of, such securities.<sup>[16]</sup> If that beneficial ownership exceeds five percent, then asset managers are required to publicly report their ownership.<sup>[17]</sup>

Congress created this reporting regime in 1968 to “provide information to the public and the subject company about accumulations of its equity securities in the hands of persons who then would have the potential to change or influence control of the issuer.”<sup>[18]</sup> Initially, all persons beneficially owning more than five percent of a public company were required to report their ownership on a Schedule 13D.<sup>[19]</sup> In 1977, pursuant to its rulemaking authority, the SEC began permitting certain categories of institutional investors to report their ownership on a shorter form.<sup>[20]</sup> This form – initially called Schedule 13D-5<sup>[21]</sup> and now called Schedule 13G<sup>[22]</sup> – requires less disclosure about the beneficial owner, is less costly to prepare, does not need to be initially filed as quickly, and does not need to be updated as frequently, when compared to Schedule 13D.<sup>[23]</sup>

#### **A. Asset Managers' Use of Schedule 13G**

Asset managers registered with the Commission under the Investment Advisers Act of 1940 are permitted to report on Schedule 13G if they satisfy two conditions.<sup>[24]</sup> First, they must have acquired the securities in the ordinary course of their business. Second, they must not have acquired, and do not hold,<sup>[25]</sup> the securities (1) with the purpose or effect of changing or influencing the control of the issuer of the securities or (2) in connection with, or as a participant in, any transaction having such purpose or effect.<sup>[26]</sup> While there are not precise statistics comparing asset managers' use of Schedule 13D versus Schedule 13G, my observation is that asset managers responsible for the largest mutual fund and ETF complexes nearly all report on the latter, implying that they believe both conditions are satisfied.

#### **B. Asset Managers' ESG Stewardship and Voting in Director Elections**

In reviewing any large asset manager's stewardship website, mentions of ESG seem ubiquitous, from voting guidelines to engagements statistics.<sup>[27]</sup> The information on these websites often document how an asset manager (1) establishes its expectations for ESG matters, (2) engages with companies

that aren't meeting its expectations, and (3) may vote against one or more incumbent directors if those companies do not continue to meet expectations. For example, an asset manager publicly disclosed a case study where, following multi-year engagements, it voted against a director of a public company, who also chaired the board committee overseeing ESG matters, because the company had failed to disclose its forward-looking GHG reduction targets. This is one of many instances in which an asset manager did not support the election of a director on the basis of climate-related issues.

### **C. Asset Managers' Control Intent or Lack Thereof**

The second condition for Schedule 13G eligibility requires that the asset manager must not have control intent with respect to the company. With respect to stewardship, does an asset manager truly lack control intent? The SEC staff has provided guidance that an asset manager's engagement with a company's management on social or public interest issues, including environmental policies, without more, would not preclude the asset manager from filing on Schedule 13G so long as the engagement is not undertaken with the purpose or effect of changing or influencing control of the company.<sup>[28]</sup> However, this guidance does not answer the question. The guidance merely reiterates that the asset manager cannot take any action with the purpose or effect of changing or influencing control. If an asset manager (1) develops ESG policies, (2) meets with companies to discuss how they are not following such policies, and (3) then votes against directors because the company's ESG practices do not match the asset manager's policies, has that asset manager done more than simply engage?

Furthermore, the staff guidance appears based on statements made in the Commission's 1998 release adopting amendments to Regulation 13D-G.<sup>[29]</sup> However, a very important change in corporate governance has occurred since then. In 1998, most board directors were elected by a plurality vote, <sup>[30]</sup> and proxy cards generally contained the voting choices of "for" or "withhold." Thus, the receipt of a single "for" vote was sufficient to elect a director in an uncontested election. Today, in contrast, a significant number of public companies have adopted some form of a majority voting provision in uncontested elections,<sup>[31]</sup> and directors may not be elected if they receive more "against" votes than "for" votes. Thus, the consequences of a company's engagement with asset managers are very different today than in 1998, as an asset manager's voting decision can be much more consequential.

With respect to whether an asset manager's engagement has the purpose or effect of changing or influencing "control" of the company, the SEC has provided a definition of "control" under the Securities Exchange Act, which means the power to direct or cause the direction of the management and policies of a company.<sup>[32]</sup> A company's ESG practices can include, among other things, its ESG strategy and goals, the timeline on which to execute, how much resources to dedicate to achieving its goals, and how much voluntary disclosure it provides with respect to the foregoing. All of these activities might be reasonably considered to be part of the "management and policies" of a company. A company's board, and particularly the members on a committee overseeing ESG matters, may have the power to direct or cause the direction of the company's ESG practices. So can an asset manager's stewardship and engagement activities – with the implicit threat of voting against a director standing for re-election – be described as having the purpose or effect of changing or influencing control of the company? In my view, that is an open question.

### **D. Disclosure of Asset Managers' Plans or Proposals for Director Elections**

Even if an asset manager is determined not to have control intent – and therefore eligible to use Schedule 13G – the Commission should consider whether additional and more timely disclosure of the

asset manager's discussions with a company's management and its voting intent should be required, either on Schedule 13G or elsewhere.

Regulation FD regulates the disclosure by a public company of material, non-public information provided to an asset manager.<sup>[33]</sup> However, other than Schedule 13D,<sup>[34]</sup> there is no requirement that an asset manager beneficially owning more than five percent of a company's voting securities disclose its communications with that company on ESG matters. To the extent that asset managers are not required to file on Schedule 13D, this dichotomy in disclosure obligations between a company and an asset manager seems at odds with a disclosure regime aimed at providing material information to all shareholders.

Another way to look at this issue is to consider a "traditional" activist shareholder that develops a financial model showing that a company would create more value for its shareholders by spinning off a business unit. The activist shareholder then approaches the company with its idea and suggests that it would vote against one or more incumbent directors if the company does not carry out its idea. If the activist shareholder beneficially owns more than five percent of the company's voting securities, then it would be generally expected to file a Schedule 13D and disclose its discussions with management. Thus, why should the conclusion be different when (1) it is the asset manager for a large mutual fund or ETF complex and (2) the idea involves ESG matters instead of a spin-off?

### III. Conclusion

In conclusion, ESG investing has been a trending topic for the past several years. As with any new trend, market participants should evaluate how their activities within this space are consistent with their legal obligations, including any applicable fiduciary duties. Additionally, the Commission should consider whether current rules capture the activities and behavior associated with the new trend, particularly with the efforts of significant shareholders to change or influence the management and policies of public companies. If so, the Commission should enforce those rules, and if not, then the Commission should evaluate whether an update to those rules is needed.

Thank you, and I hope you enjoy the rest of today's conference.

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[1] The Rise of ESG and the Future of Financial Regulation. The 2022 Cato Summit on Financial Regulation, Washington, D.C. <https://www.cato.org/events/2022-cato-summit-financial-regulation>.

[2] Saijel Kishan, *ESG by the Numbers: Sustainable Investing Set Records in 2021*, Bloomberg (Feb. 3, 2022), available at <https://www.bloomberg.com/news/articles/2022-02-03/esg-by-the-numbers-sustainable-investing-set-records-in-2021>.

[3] Isla Binnie and Ross Kerber, *Analysis: Money before climate; market downturn spurs ESG fund exodus*, Reuters (Nov. 11, 2022), available at <https://www.reuters.com/business/cop/money-before-climate-market-downturn-spurs-esg-fund-exodus-2022-11-11/>.

[4] See, e.g., Martijn Cremers, Beni Lauterbach and Anete Pajuste, *The Life-Cycle of Dual Class Firm Valuation* (June 30, 2022). European Corporate Governance Institute (ECGI) - Finance Working Paper No. 550/2018, available at [https://ecgi.global/sites/default/files/working\\_papers/documents/cremerslauterbachpajustefinal.pdf](https://ecgi.global/sites/default/files/working_papers/documents/cremerslauterbachpajustefinal.pdf); Charles C. Y. Wang and Alma Cohen, *Reexamining Staggered Boards and Shareholder Value*, *Journal of Financial Economics* 125, no. 3 (Sept. 2017): 637-647, available at

[https://www.hbs.edu/ris/Publication%20Files/SSRN-id2985152\\_cb508c76-3ade-4573-b7a5-4dd3866e4e7b.pdf](https://www.hbs.edu/ris/Publication%20Files/SSRN-id2985152_cb508c76-3ade-4573-b7a5-4dd3866e4e7b.pdf).

[5] Share Repurchase Disclosure Modernization, SEC Release No. 34-93783 (Dec. 15, 2021) [87 FR 8443 (Feb. 15, 2022)].

[6] Florian Berg, Julian F Kölbel, and Roberto Rigobon, Aggregate Confusion: The Divergence of ESG Ratings, *Review of Finance*, Vol. 26, Issue 6, Nov. 2022, p.1315–1344, available at <https://doi.org/10.1093/rof/rfac033>.

[7] *Id.*

[8] The Enhancement and Standardization of Climate-Related Disclosures for Investors, SEC Release No. 33-11042 (Mar. 21, 2022) [87 FR 21334, 21461 (Apr. 11, 2022)] (current external cost burdens of \$178,922,043 and \$1,893,793,119 for Form S-1 and Form 10-K, respectively) (“Climate-Related Disclosure Release”).

[9] *Id.* (requested change in external cost burdens of \$1,134,929,102 and \$5,166,632,876 for Form S-1 and Form 10-K, respectively).

[10] See Executive Compensation and Related Person Disclosure, Release No. 33-8732A (Aug. 29, 2006) [71 FR 53158, 53214 n. 574)] (“We recently have increased this hourly rate estimate to \$400.00 per hour after consulting with several private law firms”).

[11] See Listing Standards for Recovery of Erroneously Awarded Compensation, SEC Release No. 33-11126 (Oct. 26, 2022).

[12] Climate-Related Disclosure Release, *supra* note 8 (current external cost burdens of \$178,922,043 and \$1,893,793,119 for Form S-1 and Form 10-K, respectively, plus 1.5 times increase in external costs of \$957,722,059 and \$3,288,799,757 for Form S-1 and Form 10-K, respectively).

[13] *Id.* at 21439.

[14] Jan-Carl Plagge and Douglas M. Grim, Have Investors Paid a Performance Price? Examining the Behavior of ESG Equity Funds, *The Journal of Portfolio Management*, Vol. 46, Number 3 (Feb. 2020), available at <https://eprints.pm-research.com/17511/25030/index.html?74183>.

[15] Cole Horton and Simon Jessop, *Positive ESG performance improves returns globally, research shows*, Reuters (July 28, 2022), available at <https://www.reuters.com/business/sustainable-business/positive-esg-performance-improves-returns-globally-research-shows-2022-07-28/>.

[16] See 17 CFR 240.13d-3(a)(1).

[17] 15 U.S.C. 78m(d)(1).

[18] See Modernization of Beneficial Ownership Reporting, SEC Release No. 33-11030 (Feb. 10, 2022) [87 FR 13625, 13850 n. 23 (Mar. 10, 2022)].

[19] See Adoption of Temporary Rules and Regulations Under Sections 13(d) and (e) and Sections 14(d) and (f), SEC Release No. 34-8370 (July 30, 1968) [33 FR 11015, 11016 (Aug. 2, 1968)]. Initially in 1968, beneficial owners of more than ten percent of a company’s voting securities were required to report using Schedule 13D. In 1970, the threshold for reporting was lowered to five percent.



[20] See Beneficial Ownership Disclosure Requirements, SEC Release No. 34-13292 (Feb. 24, 1977) [42 FR 12355 (Mar. 3, 1977)].

[21] Id.

[22] Filing and Disclosure Requirements Relating to Beneficial Ownership, SEC Release No. 34-14692 (Apr. 21, 1978) [43 FR 18484 (Apr. 28, 1978)].

[23] See, generally, 17 CFR 240.13d-1(b)(2), 240.13d-2(b), 240.13d-2(c), and 240.13d-102.

[24] See 17 CFR 240.13d-3(a)(1).

[25] While Rule 13d-3(a)(1) does not reference holding securities, Item 10(a) of Schedule 13G imposes a holding requirement.

[26] This second condition contains an exception for activities solely in connection with a nomination under Rule 14a-11, which was the SEC's proxy access rule vacated by the U.S. Court of Appeals for the District of Columbia. Accordingly, the exception has no effect. However, even if it did have effect, the exception should be narrowly construed to activities in the proxy access context.

[27] See, generally, BlackRock, available at <https://www.blackrock.com/corporate/about-us/investment-stewardship>; Fidelity, available at <https://www.fidelity.com/mutual-funds/investing-ideas/sustainable-investing/stewardship-report>; State Street Global Advisors, available at <https://www.ssga.com/us/en/institutional/ic/insights/asset-stewardship-report>; and Vanguard, available at <https://corporate.vanguard.com/content/corporatesite/us/en/corp/how-we-advocate/investment-stewardship/index.html>.

[28] Question number 103.11 of Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting Compliance and Disclosure Interpretations. The guidance cites to an SEC release discussing whether a shareholder that submits, supports, or engages in exempt soliciting activity in favor of a shareholder proposal submitted pursuant to Rule 14a-8 lacks the control intent necessary to use Schedule 13G. The release provides, as an example, that most shareholder proposals on social or public interest issues, including environmental policies would lack control intent. This discussion in the release is not applicable to the discussion of control intent in the context of director elections because nearly all shareholder proposals on social or public interest issues are precatory in nature.

[29] Amendments to Beneficial Ownership Reporting Requirements, SEC Release No. 34-39538 (Jan. 16, 1998) [63 FR 2854 (February 17, 1998)].

[30] See Bo Becker and Guhan Subramanian, Improving Director Elections, Harvard Business Law Review, Vol. 3, Issue 1 (2013) (stating that majority voting in director elections began appearing in 2004), available at [https://www.hbs.edu/ris/Publication%20Files/HLB105\\_crop\\_26f06f46-bf64-4c38-8f14-d613943a1e66.pdf](https://www.hbs.edu/ris/Publication%20Files/HLB105_crop_26f06f46-bf64-4c38-8f14-d613943a1e66.pdf).

[31] Corporate Board Practices (2021 Edition), The Conference Board (by 2021, more than 90% of S&P 500 companies and more than 65% of S&P MidCap 400 companies had some form of majority voting in director elections), available at <https://corpgov.law.harvard.edu/2021/11/06/corporate-board-practices-in-the-russell-3000-sp-500-and-sp-mid-cap-400/>.

[32] 17 CFR 240.12b-2.

[33] See 17 CFR 243.100.

[\[34\]](#) Item 4(d) of Schedule 13D requires the shareholder to disclose plans or proposals that relate to or would result in any change in the present board of directors or management of the subject company.