Securities Regulation Daily Wrap Up, TOP STORY—House members quarrel over mandating ESG disclosure, (Feb. 26, 2021)

Securities Regulation Daily Wrap Up

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While Democrats voiced support for requiring the disclosure of some ESG issues, Republicans decried mandated disclosure as an attempt to "name and shame corporate villains."

The House Subcommittee on Investor Protection, Entrepreneurship and Capital Markets recently heard from witnesses about requiring the disclosure of environmental, social, and governance (ESG) criteria in public company filings and the pros and cons of mandating such disclosure. While environmental factors dominated the discussion, the subcommittee also discussed issues related to board diversity and corporate responsibility.

Shareholders, stakeholders, and mandatory disclosures. Subcommittee Chairman Brad Sherman (D-Calif) said that today's shareholders expect more from companies than simply dividends and earnings per share (EPS) numbers. More and more shareholders want information on ESG factors, especially regarding the effects of climate change on the company and its bottom line. According to Sherman, shareholders want defined numerical standards to inform their investment decisions, and not just an extra page or two on Form 10-K with banal statements and greenwashing by the company. In addition, corporations are aware of the concerns of not only shareholders, but also stakeholders, Sherman said. Stakeholders include all of society at large, which protects the corporation and its property. Stakeholders want to know what the company is doing, he remarked.

While the annual report on Form 10-K should not be turned into a phone book with too many added disclosures, Sherman said that certain disclosures on climate change, environmental issues, and social justice are important to investors. This includes disclosures on hidden political contributions by corporations, executive compensation versus the average worker pay, and issues related to the company's tax payments, Sherman said.

Subcommittee Ranking Member Bill Huizenga (R-Mich) acknowledged that many investors want information about climate, environmental, and social issues. However, he questioned the need for imposing new disclosure requirements on companies related to these types of disclosures. Huizenga noted that under investor pressure, many companies have voluntarily disclosed ESG matters. The movement to mandate these disclosures is politically motivated and is a means to "name and shame" what some call "corporate villains," Huizenga proclaimed. He also took issue with the name of the hearing, entitled "Climate Change and Social Responsibility: Helping Corporate Boards and Investors Make Decisions for a Sustainable World." This is not "helping" boards and investors, Huizenga said. It's mandating disclosures that may not be wanted.

Witness views. The subcommittee heard from five witnesses—four sympathetic to mandated ESG disclosure and one who expressed his concern that stakeholder capitalism and ESG "allies" place demands on companies to determine society's core values. Andy Green of the Center for American Progress voiced his support for requiring the disclosure of climate-related risks and more broadly, ESG-related disclosures such as worker practices, gender and race diversity, tax transparency, human rights, and political spending. Making corporations take account of ESG matters and sustainability will help make capitalism work, he said.

Heather McTeer Toney, Climate Justice Liaison of the Environmental Defense Fund and former mayor of Greenville, Mississippi, spoke about the impact on disadvantaged communities of the failure of corporations to recognize and calculate the risk of climate change. She discussed the "invisible investor—the American taxpayer." The brunt of expenses for dealing with climate change fall on communities of color and economically depressed regions, she said. Strengthening climate risk disclosure is a necessity for more than markets and investors, Toney implored.

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Veena Ramani of Ceres and James Andrus of CalPERS also expressed their support for mandatory ESG disclosure. Ramani acknowledged Rep. Huizenga's remarks that companies have increased their ESG disclosures on a voluntary basis. However, even though voluntary disclosures have gone up, these disclosures are not high quality and lack comparable data, she advised. Andrus also agreed that voluntary disclosures are not adequate substitutes for regulatory actions. Regarding board diversity, Andrus said that diversity helps companies improve their performance over the long-term because the differing backgrounds, experiences, and perspectives help management address risk and seize opportunities in a holistic manner. He advocated that boards annually disclose their demographic information including race, ethnicity, and gender under Regulation S-X and Regulation S-K.

Vivek Ramaswamy, the former CEO of a biotech company, took a decidedly different stance from his fellow panelists. Decrying "stakeholder capitalism," Ramaswamy stated that when companies pursue social causes in addition to shareholder interests, companies and investors must first define what those other societal interests should be. "That is not a business judgment. It is a moral judgment," Ramaswamy said.

Voluntary disclosure on ESG. Ramaswamy was a sympathetic witness when questioned by committee Republicans. Pressed by Rep. Huizenga on the decline in initial public offerings in recent years and whether under new ESG disclosure requirements, the number of new public companies would continue its downward spiral, Ramaswamy said that adding one additional disclosure, such as a climate-related disclosure, might not do so. But if the SEC decides to require climate disclosure, it could open a Pandora's box of ESG-related disclosures, which may dissuade companies from wanting to go public, he said.

When asked by Rep. Steve Stivers (R-Ohio) whether shareholders already have the ability to get information on ESG issues, Ramaswamy said that while a particular disclosure may be worthy, it does not need to be mandated. Investors wield the power to get that information. Representative Ann Wagner (R-Mo) also noted that several companies have been making investments in renewable energy due to the free market and questioned the need for more mandated environmental disclosure. According to Wagner, any new regulatory activities should prioritize deregulation to lift up the capital markets.

Not all committee members were ready to cede ESG disclosure to a voluntary regime. Representative Sean Casten (D-Ill) posited the question if complying with GAAP and with related-party transactions were voluntary, would companies do so, providing an analogy to consistent and standard ESG disclosures. Andrus agreed, and reemphasized that CalPERS just wants honest and fair disclosures so it can make better investment decisions. This includes standardized disclosures on certain ESG issues.

Casten also took the opportunity to rebut Huizinga about a point he made regarding a study which found that there was no correlation between ESG rankings and stock performance. Casten pointed out that the study used voluntary disclosures, emphasizing that mandatory disclosures were necessary. When asked by Casten about the reliability of voluntary disclosures, Ramani confirmed that a vast amount of climate change disclosure is not externally verified.

Diversity and underserved communities. Representative Gregory Meeks (D-NY) brought up a recent proposal by Nasdaq to increase diversity among boards of directors. The proposed rule would require listed companies to have, or explain why they do not have, at least one or two diverse directors. The proposal is opposed by the Republican members of the Senate Banking Committee. Meeks asked Andrus if the SEC's current disclosures on board diversity are inadequate. Andrus replied that they are because the only thing companies have to do now is say that they have taken steps toward board diversity. Andrus compared the U.S. to Europe, which has mandated board diversity for women and advocated federal action in the U.S. on this issue.

Meeks also noted that his bill, Improving Corporate Governance Through Diversity Act of 2021, would mandate disclosure not only of board member diversity, but also the diversity of the executive "C-suite." Meeks inquired if such disclosure is as important as board diversity, to which Andrus replied that in some cases it is even more important—shareholders can cast votes on the board of directors but have no say on the executives.

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In Andrus's testimony, he mentioned a study that there is a positive relationship between the percentage of diverse individuals on boards and firm value and performance. Representative Warren Davidson (R-Ohio) queried Andrus why further regulation is needed if studies show that diverse corporate boards lead to better corporate performance and why the government needs to tell companies how to structure their boards. Andrus replied that boards should be required to be diverse so they can ensure that they use all the talent available in the country and to mindfully guard against the risk of operating with all-white boards. Andrus also touted the efforts in other countries that have mandated certain board requirements for women as a positive impact.

Ramaswamy took a different view when questioned by Davidson. According to Ramaswamy, diversity of metrics on a checkbox form, which is supposed to bring a diversity of experience and thoughts from diverse perspectives, will create only the appearance of the diversity of thought.

Maxine Waters (D-Calif), chair of the full House Financial Services Committee, asked Toney about the impact of climate change on disadvantaged communities and communities of color and how requiring more disclosure from companies about climate change could address these risks. Waters noted in particular the impact of the recent freezing conditions in Texas on minority communities.

Toney said that decisions made with a lack of disclosure is a disclosure in and of itself. Investors need to know the impact of how climate impacts labor forces in areas affected by climate change, such as food workers and airlines and how coffee beans are grown. These are issues where the labor force is often black and brown, and the assets of the company are located in black and brown communities, Toney advised.

Acting Chair Lee's statement on climate disclosures. Prior to the hearing, Acting SEC Chair Allison Herren Lee issued a statement directing the SEC's Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings. In her statement, Lee echoed a theme espoused by some of the witnesses at the hearing: "Now more than ever, investors are considering climate-related issues when making their investment decisions."

Lee has long been an advocate of disclosure of climate-related disclosures. In a November 2020 speech, Lee declared, "One real risk looms even larger than the pandemic and could have even more grave human and economic costs than those we have witnessed these last eight months. That risk arises from climate change." She has also expressed disappointment at the Commission's lack of action on climate change, including the SEC's approval of amendments to Regulation S-K disclosures.

Lee has directed CorpFin to review the extent to which public companies address the topics identified in the long-ignored 2010 guidance on climate change, assess compliance with disclosure obligations under the federal securities laws, engage with public companies on these issues, and absorb critical lessons on how the market is currently managing climate-related risks.

Not dissuaded by her acting chair capacity, Lee has seized the moment to implement other aggressive polices. Regarding the SEC's enforcement capabilities, Lee has already proclaimed a policy severing the SEC's settlement process from its waiver process. She also relaxed the Enforcement Division's subpoena policy to allow senior officers subpoena power.

Speaking during the hearing, Ramani brought up Lee's statement and noted that the 2010 guidance explains how existing disclosure rules can be applied to climate risk. She added that the guidance has not been enforced. She urged the SEC to act on climate risk disclosure.

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