Speech

# Remarks at the Georgetown Law Hotel and Lodging Summit

**Commissioner Mark T. Uyeda**

**Washington D.C.**

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Good afternoon everyone.  Thank you, Bob [Lannan], for the kind introduction.  I'm pleased to share some thoughts on climate disclosure, which reflect my individual views as a Commissioner and do not necessarily reflect the views of the full Commission or my fellow Commissioners.

In March 2022, the Commission proposed sweeping changes for issuers regarding climate change disclosures.[1] Two months later, the Commission proposed additional rules for funds to incorporate environmental, social, and governance (ESG) factors into their disclosures.[2]  These ambitious proposals have received robust public comment and for good reason.  These proposals – both staggering in their complexity and reach - are merely two proposals among an exceedingly packed SEC regulatory agenda.[3]

I will focus on two topics: the concept of "materiality" in the federal securities laws and the comparability of ESG disclosure in fund documents.

## ESG

With respect to public companies, the Commission proposed to add an entirely new section to Regulation S-K for climate disclosure.  Larger public companies would be subject to an attestation requirement for some of the proposed greenhouse gas (GHG) emissions metrics disclosures.  Further, the Commission proposed a new article to Regulation S-X requiring certain climate-related financial statement metrics and related disclosure to be included in the notes to the financial statements.  As part of the financial statements, they would be subject to audit by an independent auditor, and be subject to the registrant's internal control over financial reporting.

It may be useful to look at the past to better understand where we are today.  ESG's roots can be traced back to socially responsible investing (SRI).[4]  In the 1970s and 1980s, the term gained prominence due to social concerns about the Vietnam War and apartheid policies in South Africa.  In the early 2000s, SRI began to incorporate governance factors due to, among other things, the collapse of Enron and other corporate scandals.

Today, SRI has transformed into ESG.  While seemingly simple, environmental, social, and governance factors encompass a multitude of sub-issues.  Adding to the murkiness is the subjectivity of how investors and issuers consider ESG.  Should ESG reflect the impact that a company has on the welfare of its stakeho environment, or should it measure the impact societal and environmental factors have on the cc

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example, is a hypothetical company that produces so-called “green” technology but has substantial worker safety issues a better ESG investment than an energy company whose products promote economic growth and result in the reduction of poverty, famine, and suffering?

Some have argued the Commission-mandated ESG disclosure is necessary to address concerns about interpretative issues involving what is E, S, and G and the challenges that corporate issuers and investors face with respect to ESG rating firms.[5] Critics of ESG rating firms have raised concerns that the methodologies are opaque and that it is difficult to understand how a company is rated.[6] Companies may find it challenging to correct information that is outdated or incorrect and find themselves responding to a multitude of ESG surveys requesting data and other information over different time periods, thus raising costs and stretching scarce resources.

While these may be valid concerns about ESG ratings and the firms that provide them, it is an open question as to whether the Commission must step in and mandate uniform disclosure requirements. If past is prologue, then investor and third-party views of what ESG disclosure is important – and what the E, S, and G mean - will likely shift over time. Once hard-wired into the SEC rule book, regulations have a tendency not to be subject to retrospective review for a long time. For example, it took the SEC over 30 years to review its disclosures regime for banks and savings and loan registrants.[7] Prescriptive Commission rulemaking may not be sufficiently nimble or effective with respect to these types of disclosures.

This brings me to my next point: the continued importance of financial materiality to our disclosure regime.

## Materiality

Materiality is the cornerstone of our federal securities laws. In fact, the word “material” was part of the original Securities Act of 1933, also known as the “Truth in Securities Law.”[8] “Materiality” was aptly framed in 1976, when Justice Thurgood Marshall of the Supreme Court, in TSC Industries v. Northway, explained in an 8-0 opinion that a fact is “material” if there is “a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote,” and where the disclosure of would have been viewed by the reasonable investor as “having significantly altered the ‘total mix’ of information made available.”[9] The Supreme Court reiterated this definition in Basic v. Levinson in the context of a securities fraud case.[10]

It is important to note the context of TSC Industries v. Northway. The proxy vote at issue centered on the acquisition of TSC Industries by National Industries, in which shareholders were being asked to approve the proposed exchange of TSC common and Series 1 preferred stock for National Series B preferred stock and warrants.[11] This was a quintessential investment decision involving the appropriate enterprise value of two different entities, not a vote on a routine matter or a non-binding shareholder proposal.

Thus, the Supreme Court cautioned that “[s]ome information is of such dubious significance that insistence on its disclosure may accomplish more harm than good.”[12] Justice Marshall observed that “if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information -- a result that is hardly conducive to informed decisionmaking.”[13]

Today, some have suggested that a broadening of materiality to encompass “qualitative” materiality, or the European Union’s “double materiality.”[14] They would replace financial materiality with a more outcome-driven approach based on their perspective of the public good.

This approach is not new. Then-SEC Commissioner Roberta Karmel captured these issues in 1978:

> As greater numbers of Americans become owners of our large public corporations, whether individually or through institutional investors, and as corporations become subject to in
> government regulation, the dialogue between shareholders and their corporations becc

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> of a larger political process. Nevertheless, and despite the legitimate concerns of ethical investors, I believe we should exercise caution in applying a non-economic standard of materiality to disclosure requirements… Because some investors may want certain information in order to make an investment or voting decision does not mean that mandatory disclosure of such information would be necessary or appropriate in the public interest or for the protection of investors.[15]

If we move away from a materiality that is focused on financial returns, we risk a regime that is subject to the whims of the administration in power – regardless of its political affiliation. And such a regime will likely increase the costs and complexity of disclosure, alongside increased litigation. More importantly, it will be Main Street investors who will ultimately bear these costs.

## ESG and Fund Disclosures

I will now turn to ESG and fund disclosures. You may wonder why I am discussing ESG fund disclosure at the Hotel and Lodging Summit. Mutual funds and exchange-traded funds (ETFs), however, serve important functions for your businesses, whether through owning your company's stock and bond holdings or serving as 401(k) investment options for your employee benefit plans.

Some statistics: as of December 31, 2021, U.S. registered open-end funds, which include mutual funds, closed-end funds, ETFs and unit investment trusts, had $34.6 trillion of assets under management.[16] They own 32% of U.S. corporate equity and 24% of U.S. and foreign corporate bonds. In terms of the retirement market, $12.6 trillion of defined contribution and IRA assets are invested in funds.[17]

Therefore, regulation that affects funds – particularly regulation that increases costs and compliance burdens – will likely affect your interactions with asset managers.

In May of this year, the Commission proposed disclosure and other changes that would greatly impact fund disclosure. The proposal would require additional specific disclosure requirements regarding ESG strategies to investors in fund registration statements, the management discussion of fund performance in fund annual reports, and adviser brochures.[18] The proposal contains minimum disclosure requirements for any fund that markets itself as an ESG-focused fund or an integration fund.[19] ESG-focused funds would be required to disclose two specific GHG emissions metrics for the portfolio in such funds' annual reports.[20]

The Commission chose not to define "ESG" for purposes of the proposal and instead asked questions as to whether it should define "ESG."[21] That was an interesting choice, because many obligations under the proposal are only required if ESG factors are considered. But the scope as to what is, and what is not, an ESG factor can be elusive.

At least one other regulator gave up on trying to define what is an ESG factor. When the Department of Labor adopted a final rule guiding the investment decisions of fiduciaries under the Employee Retirement Income Security Act, it concluded that "'ESG' terminology, although used in common parlance when discussing investments and investment strategies, is not a clear or helpful lexicon for a regulatory standard."[22] Moreover, the Department found that "the terms do not have a uniform meaning and the terminology is evolving, and the non-pecuniary goals being advocated today may not be the same as those advocated in future years."[23]

I appreciate the comments that have been submitted on the ESG fund proposal. While the rulemaking raises many important issues to consider, today I will focus on comparability. Notably, in proposing the rule, the Commission claimed that "[t]he proposed rules and form amendments are designed to create a consistent, comparable, and decision-useful regulatory framework for ESG advisory services and investment companies to inform and protect investors while facilitating further innovation in this evolving area of the asset management industry."[24]

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Over the years, the Commission has made significant strides in requiring fund disclosure that is comparable, useful, and appropriately tailored to provide fund investors with the information they need to make investment decisions. For example, in 1998, the Commission adopted rules to standardize fee table disclosure so that investors could quickly and easily compare fund fees.[25] In 2009, the Commission required funds to include a summary in the beginning of their prospectus.[26] The summary sets forth key information that investors need to make an investment decision, in plain English, and in a standardized order to facilitate comparisons among funds.

Notably, these reforms did not generally mandate how funds should characterize their investment objectives or strategies, or otherwise force funds into prescriptive boxes. Instead, the reforms focused on ensuring that disclosure was presented in a particular, systematic order, and that quantitative information – such as the fee table and performance chart – was presented and calculated uniformly. When I compare these reforms to the current proposal, I wonder whether ESG disclosure – even for funds that pursue an ESG strategy – is appropriate for a check-the-box disclosure approach.[27] As ESG has different meanings and utility to different stakeholders, reducing ESG to specified categories risks making the disclosure potentially misleading – at worst – or confusing or unhelpful, at best.

## Next Steps

The Commission has received a large number of comment letters on the climate-related proposal for issuers and the ESG proposal for funds. The staff is in the process of reviewing these comments and formulating recommendations for next steps.

Finally, I am concerned about the pace and breadth of the Commission's regulatory agenda in general and with respect to ESG-related rulemaking.[28] With inflation at record highs, supply chain concerns, labor shortages, and the continuing effects of the pandemic on the economy, businesses continue to struggle. We should not overwhelm firms with significant and costly new regulations. Indeed, many sectors, including the hotel and lodging industry, are straining under the renewed demand for their services as we emerge post-pandemic. A poorly coordinated implementation period for any new regulations can create adverse effects on businesses and give short shrift to the Commission's mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

Thank you.

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[1] The Enhancement and Standardization of Climate-Related Disclosures for Investors, SEC Release No. 34-11061 (May 9, 2022) [87 FR 21334 (Apr. 11, 2021)], available at https://www.federalregister.gov/documents/2022/04/11/2022-06342/the-enhancement-and-standardization-of-climate-related-disclosures-for-investors.

[2] Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Practices, SEC Release No. 33-11068 (May 25, 2022) [87 FR 36654 (June 17, 2022)] ("ESG Proposing Release"), available at https://www.federalregister.gov/documents/2022/06/17/2022-11718/enhanced-disclosures-by-certain-investment-advisers-and-investment-companies-about-environmental.

[3] SEC Announces Spring 2022 Regulatory Agenda, Press Release No. 2022-112 (June 22, 2022), available at https://www.sec.gov/news/press-release/2022-112.

[4] Max M. Schanzenbach & Robert H. Sitkoff; *Article: Reconciling Fiduciary Duty and Social Conscience; the Law and Economics of ESG Investing by a Trustee*; 72 Stan. L. Rev. 381 (Feb. 2020).

[5] See, e.g., Investor-as-Owner Subcomm., SEC Inv. Advisory Comm., Recommendation Relating to ESG Disclosure 1-2 (May 14, 2020), available at https://www.sec.gov/spotlight/investor-advisory-committee-2012/esg-disclosure.pdf.

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[6] See David F. Larcker, Lukasz Pomorski, Brian Tayan, and Edward M. Watts, *ESG Ratings: A Compass without Direction,* Rock Center for Corporate Governance at Stanford University (Aug. 2, 2022).  See also Bridget Hickey, Vanguard, Baird, Ariel Labelled ESG Laggards, FundFire (Oct. 18, 2022).

[7] Update of Statistical Disclosures for Bank and Savings and Loan Registrants, SEC Release No. 33-10835 (Sept. 11, 2020) [85 FR 66108 (Oct. 16, 2020)], available at https://www.federalregister.gov/documents/2020/10/16/2020-20655/update-of-statistical-disclosures-for-bank-and-savings-and-loan-registrants.

[8] See David A. Katz and Laura A. McIntosh, “Materiality” in America and Abroad, N.Y.L.J., Apr. 29, 2021, at p.5, col.1; Vol. 265; No. 80.

[9] TSC Industries v. Northway, 426 U.S. 438 (1976).

[10] Basic Inc. v. Levinson, 485 U.S.224, 231 (1988).

[11] 426 U.S. 440-41.

[12] Id. at 448.

[13] Id. at 448-49.

[14] Ruth Jebe, *Article: The Convergence of Financial and ESG Materiality: Taking Sustainability Mainstream,* 56 Am. Bus. L.J.  645, 659 (Fall, 2019).

[15] Commissioner Roberta S. Karmel, Changing Concepts of Materiality, Speech before the National Investor Relations Institute (Apr. 12, 1978), available at https://www.sec.gov/news/speech/1978/041278karmel.pdf.

[16] Investment Company Institute, 2022 Fact Book, available at https://icifactbook.org/pdf/2022_factbook.pdf.

[17] Id.

[18] ESG Proposing Release, supra note 2.

[19] Id. at 36657.

[20] Id. at 36659.

[21] Id. at 36660.

[22] Financial Factors in Selecting Plan Investments, Employee Benefits Security Administration, Department of Labor 85 FR 72846, 72857 (Nov. 13, 2020).

[23] Id.

[24] ESG Proposing Release, supra note 2.

[25] Final Rule: Registration Form Used by Open-End Management Investment Companies, SEC Release No. 33-7512 (Mar. 13, 1998) [63 FR 13916 (Mar. 23, 1998)].

[26] Enhanced Disclosure and New Prospectus Delivery Options for Registered Open-end Investment Management Companies, SEC Release No. 33-8998 (Jan. 13, 2009) [74 FR 4546 (Jan. 26, 2009)].

[27] See, e.g., Jacob Rund, *SEC Urged by Advisory Panel to Tackle ESG Disclosures*, Bloomberg Law (May 21, 2020), available at https://news.bloomberglaw.com/esg/sec-urged-by-advisory-panel-to-tackle-esg-disclosures, noting the following remarks by Stephen Holmes: "I don't think many people would benefit from what would probably be a massive amount of boiler plate legalese or a master manual with lots of boxes to be checked."

[28] Commissioner Hester M. Peirce, RIP Current Rulemakings: Statement on the Regulatory F
(June 2, 2022), available at https://www.sec.gov/news/statement/peirce-statement-regulatory-fle

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