April 28, 2020

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

FILE NUMBER S7-01-20: MANAGEMENT'S DISCUSSION AND ANALYSIS, SELECTED FINANCIAL DATA, AND SUPPLEMENTARY FINANCIAL INFORMATION

Dear Ms. Countryman,

The Principles for Responsible Investment ("PRI") welcomes the opportunity to submit comments on File Number S7-01-20: Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information ("Proposed Rule").

The PRI is the world's leading initiative on responsible investment.[1] It works to understand the investment implications of environmental, social and governance (ESG) factors and to support its international network of 3,000 investor signatories in incorporating these factors into their investment and ownership decisions. Launched in New York in 2006, the PRI's signatories manage over $90 trillion in AUM.[2] The US is the PRI's largest market, with over 550 signatories[3] investing over $45 trillion in AUM.

Signatories to the PRI commit to six principles to advance their own responsible investing activities that include the incorporation of ESG analysis into their investment decisions. Signatories to the PRI consistently voice that lack of access to consistent, comparable information on ESG factors is a barrier to their efforts to integrate ESG factors into their investment decisions effectively. The comments on the Proposed Rule that follow are guided by the PRI's efforts to advance policies that will improve signatories' access to such information.

SUMMARY

As previously stated in its comment letter regarding the Commission's proposed revisions to Items 101, 103 and 105 of Regulation S-K,[4] the PRI agrees with the Commission's assessment that

[1] Principles for Responsible Investment (The PRI), *What are the Principles of Responsible Investment?* available at: https://www.unpri.org/pri/an-introduction-to-responsible-investment/what-are-the-principles-for-responsible-investment.
[2] As of March 30, 2020.
[3] As of March 30, 2020.
[4] The PRI, Comment Letter to Securities & Exchange Commission, *Modernization of S-K Items 101, 103, and 105* (Oct. 30, 2019) available at: https://www.sec.gov/comments/s7-11-19/s71119-6368809-196430.pdf.

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Regulation S-K should be modernized and updated. We are encouraged by Chairman Clayton's and the Commission's interest in hearing from market participants on environmental and climate-related risk disclosures and models,[5] and the Commission's participation with the International Organization of Securities Commissions (IOSCO) on its final report on sustainable finance and the role of securities regulators.[6]

However, the PRI is concerned about two issues in particular with the Proposed Rule. First, the SEC did not adequately quantify the costs and benefits of the proposed new principles-based disclosures in the MD&A of issuers' annual filings; those costs are critical for issuers and investors alike to understand before the SEC proceeds with giving management more discretion to shape disclosures. Second, the PRI is concerned about the SEC's failure to require any new climate-risk disclosures in the Proposed Rule. Accordingly, the PRI recommends that: (1) the SEC revise the Proposed Rule's economic analysis to better quantify the costs and benefits of the proposed principles-based disclosures; and (2) climate-related disclosures be included as part of the Commission's disclosure modernization effort under Regulation S-K.

Finally, in response to Chairman's Clayton request, the PRI hopes its ongoing detailed quantitative assessment of portfolio risks investors face, known as the Inevitable Policy Response (IPR), as a result of abrupt policy shifts in response to climate change will be useful to the Commission as it seeks more information about how market participants are evaluating environmental risk factors.

I. Proposed Rule Regarding Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information

A. The SEC Needs to Empirically Study the Costs and Benefits of Increasing Principles-Based Disclosures Before Finalizing the Proposed Rule

As with the SEC's recent Regulation S-K proposal,[7] the Proposed Rule continues a trend towards the use of more principles-based disclosure. Specifically, the Commission proposes to replace Item 303(a)(4), regarding off-balance sheet arrangements, with a principles-based instruction to prompt registrants to discuss off-balance sheet arrangements in the broader context of the MD&A.[8]

The PRI is concerned that the SEC has not adequately weighed the benefits of this additional flexibility against its costs. For one, principles-based rules give management and their lawyers increased discretion to shape disclosures. For another, if there is less disclosure (or less useful disclosure), this results in a higher cost of capital, as investors demand compensation for the additional amounts they must spend to understand the risks they're taking.

Although the economic analysis does *qualitatively* discuss certain costs, stating, "We acknowledge the risk that emphasizing the current principles-based approach may result in certain loss of information to investors," the Commission needs to provide additional specificity and *quantification* of

[5] Securities & Exchange Commission, Statement of Chairman Jay Clayton, *Proposed Amendments to Modernize and Enhance Financial Disclosures; Other Ongoing Disclosure Modernization Initiatives; Impact of the Coronavirus; Environmental and Climate-Related Disclosure* (Jan. 30, 2020).
[6] Board of IOSCO, *Sustainable Finance and the Role of Securities Regulators and IOSCO, Final Report* (April 2020) available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD652.pdf.
[7] PRI, *Comment on S7-11-19, Modernization of S-K Items 101, 103, and 105* (Oct. 30, 2019) available at: https://www.sec.gov/comments/s7-11-19/s71119-6368809-196430.pdf.
[8] Securities & Exchange Commission, Proposed Rule, *Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information,* File No. S7-01-20 (Jan. 30, 2020).

how the market would respond to the increased flexibility it is granting to issuers. For example, issuers could respond to the increased flexibility by increasing the use of boilerplate language in their MD&A. Indeed, academic research finds a marked increase in the use of boilerplate language in Form 10-K disclosures between 1996 and 2013.[9] Other research finds that within MD&As, managers have increasingly used boilerplate disclosure, with the authors concluding that "the price responses to MD&A modifications have weakened over time" and observing "a decline in MD&A usefulness in recent years."[10] Another study finds a relationship between the disclosure of boilerplate to less liquidity, analyst coverage, and institutional ownership.[11] Unfortunately, none of these studies were cited in the Proposed Rule.

In other words, there are a number of plausible ways the SEC could empirically study the costs of moving to a more principles-based disclosure regime. Quantifying those costs is critical for issuers and investors alike to understand before the SEC proceeds with giving management more discretion to shape disclosures. Accordingly, the PRI urges the SEC to revise the Proposed Rule's economic analysis to carefully quantify the costs and benefits of the proposed principles-based disclosures.

B. The SEC Is Again Missing an Opportunity to Require Climate-Related Risk Disclosures

The PRI is concerned that the Commission is missing a critical opportunity in the Proposed Rule by failing to require issuers to disclose climate-related risks. As numerous investors, including the PRI, have noted to the SEC time and again, there is increasing evidence of the importance of ESG integration and long-term financial performance.[12]

The Commission's decision in the Proposed Rule not to further develop climate-related disclosure requirements relegates such disclosures to a voluntary, privately ordered disclosure system. This has resulted in a patchwork quilt of disclosures that are unduly complex, lack comparability, and that undermine investors' ability to effectively integrate climate-related risks into investment processes and decisions. It also impacts retail investors who do not have the time, resources, or leverage to ask issuers for the information needed to understand climate-related effects on their portfolios. This is precisely the type of information asymmetry our century-old securities laws were designed to remedy.

While some might argue that climate change risks must already be disclosed if material, the Commission's current approach invites corporate management to disclose material risks in a manner that may be less usable for investors. Indeed, the Commission has maintained rules on required

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[9] Travis Dyer, Mark H. Lang & Lorien Stice-Lawrence, *The Evolution of 10-K Textual Disclosure: Evidence from Latent Dirichlet Allocation,* J. Accounting & Economics, forthcoming, at Fig. 5, panel B (March 7, 2016) available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2741682.

[10] Stephen v. Brown & Jennifer Wu Tucker, *Large-Sample Evidence on Firms' Year-over-Year MD&A Modifications*, Journal of Accounting Research, Vol. 49 (2), at 4 (Aug. 17, 2009) available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1452977.

[11] Mark Lang & Lorien Stice-Lawrence, *Text Analysis and International Financial Reporting: Large Sample Evidence,* J. Accounting & Economics, forthcoming, at 17 (March 13, 2014) (finding that for a sample of non-U.S. firms, "[l]iquidity, analyst following, and institutional ownership tend to be greater for firms whose annual reports are longer, contain less boilerplate and Fog") available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2407572.

[12] *See, e.g.,* Deutsche Asset & Wealth Management, the University of Hamburg, and the PRI, *ESG & Corporate Financial Performance: Mapping the global landscape* (Dec. 2015) available at: https://institutional.dws.com/content/_media/K15090_Academic_Insights_UK_EMEA_RZ_Online_151201_Final_(2).pdf; The PRI, *Financial performance of ESG integration* (Feb. 20, 2018) available at: https://www.unpri.org/investor-tools/financial-performance-of-esg-integration-in-us-investing/2738.article.

disclosure of material environmental issues[13] and more recent Commission Guidance Regarding Disclosure Related to Climate Change, issued in 2010.[14] But those rules have not produced sufficient disclosure that is decision-useful.[15] Limiting required disclosure to corporate managers' narrower aperture of what is material or not puts both investors and companies at risk.

In contrast, for decades, the SEC considered materiality from the perspective of what information *investors* are demanding.[16] And there is now a clamoring from shareholders for climate risk disclosure: climate risk is regularly one of top shareholder proposal categories, and countless letters from investors have been sent to the SEC requesting a mandatory rule on the topic.[17] That should be important evidence for the Commission of the materiality of these risks.

To be clear, the PRI is encouraged by the SEC's engagement with international counterparts, notably with the Commission's participation in the final report on sustainable finance and the role of securities regulators and IOSCO.[18] We urge the Commission to continue to closely engage with international regulatory bodies as international rules on ESG disclosure and classification continue to evolve. In particular, the Financial Stability Board's Task Force for Climate-related Financial Disclosures (TCFD) provides valuable examples of climate-related financial disclosures that the Commission could use to develop a disclosure framework for US issuers. The TCFD framework is the most used framework by US issuers; it now has global support from over 1,000 organizations representing $12 trillion, including BlackRock, one of the founding members.[19] This year, PRI signatories are also required to report on climate change using TCFD-based indicators,[20] and many US companies, including Exxon and Chevron, rely on the TCFD framework.[21]

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[13] *See, e.g.,* 17 C.F.R. § 229.101 (Item 101) Description of business ("Appropriate disclosure also shall be made as to the material effects . . . relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries.).

[14] Securities & Exchange Commission, *Commission Guidance Regarding Disclosure Related to Climate Change*, Release No. 33-9106; 34-61469 (Feb. 8, 2010) available at https://www.sec.gov/rules/interp/2010/33- 9106.pdf.

[15] Ceres, *SEC Climate Guidance & S&P 500 Reporting – 2010-2013* (Feb. 2014) In 2014, for example, Ceres researchers conducted a retrospective review of S&P 500 issuers' filings after the 2010 guidance. They found that on the whole issuers did not report "company specific information" or "quantify [] risks or past impacts." Rather, they found that issuers tended to use "boilerplate language of minimal utility to investors" that only "briefly discussed" climate change. Available at: https://www.ceres.org/sites/default/files/reports/2017-03/Ceres_SECguidance-append_020414_web.pdf.

[16] *See* The PRI, Comment Letter to Securities & Exchange Commission, *Amendments to Modernize Shareholder Proposal Rule;* (Feb. 3, 2020) (noting that the "development of the SEC's disclosure regime, however, has often occurred in response to interest from investors, including through shareholder resolutions" and listing several examples of investor-driven disclosure rules, dating back to the 1970s) available at: https://www.sec.gov/comments/s7-23-19/s72319-6740609-207727.pdf.

[17] *See* Heidi Welsh, Michael Passoff, and Andrew Behar, *Proxy Preview 2019* (April 1, 2019) ("The topic of climate change makes up the vast majority of resolutions filed on environmental issues and undergirds many other corners of shareholder activity this proxy season.") available at: https://corpgov.law.harvard.edu/2019/04/01/proxy-preview-2019/; *see Comments on Request for rulemaking on environmental, social, and governance (ESG) disclosure*, File No. 4-730 (Oct. 2018) ("In recent years, there have been a number of significant petitions and other investor proposals seeking expanded disclosure of ESG information.") available at: https://www.sec.gov/rules/petitions/2018/petn4-730.pdf.

[18] *See* Board of IOSCO, *Sustainable Finance and the Role of Securities Regulators and IOSCO, Final Report* (April 2020) available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD652.pdf.

[19] TCFD, *TCFD Supporters* (as of February 2020, "support for the TCFD has grown to over 1,027 organizations, representing a market capitalization of over $12 trillion.") available at: https://www.fsb-tcfd.org/tcfd-supporters/. Support does not indicate that these organizations are reporting against the TCFD in a uniform manner.

[20] *See* The PRI, *PRI FAQ on mandatory climate reporting for PRI signatories*, available at: https://www.unpri.org/reporting-for-signatories/faq-on-mandatory-climate-reporting-for-pri-signatories/5356.article.

[21] *See* Chevron, *Climate Change Resilience: A Framework for Decision Making* (March 2018) ("The table below shows how the disclosures in this report align with the recommendations of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD), as the TCFD has described the categories and where the relevant information can be found in this report") available at: https://www.chevron.com/-/media/shared-

That said, with the increase of disruptions from severe weather events and even pandemics like COVID-19, the status quo subjects issuers and investors to risks from difficult-to-understand, "business as usual" projections that omit the effects of climate change and other related business disruptions. This is the kind of issue that should be ripe for review within the context of the SEC's efforts to modernize Regulation S-K, and the PRI urges that climate-related disclosures be included in this effort.

II. Chairman Clayton's Request for Information on Environmental and Climate Risk Assessments: The PRI's 'Inevitable Policy Response'

In his public statement accompanying the Proposed Rule, Chairman Clayton expressed interest in, among other issues, "better understanding the environmental and climate-related information investors currently use and how they analyze that information to make investment decisions on both an issuer- and industry-specific basis and more generally" and "discussing with asset managers that have been using environmental and climate-related models and metrics to allocate capital on an industry or issuer specific basis their experience with that process."[22] The PRI believes that financial markets today have not adequately priced-in the likely near-term *policy* response to climate change. Yet as the realities of climate change become increasingly apparent, it is inevitable that governments will be forced to act more decisively than they have so far. Accordingly, the PRI requests the SEC consider this project, called the Inevitable Policy Response (IPR), which is designed to prepare investors, as well as policymakers, to manage the portfolio risks associated with this abrupt climate policy transition.[23]

The IPR has three main parts: (1) a Forecast Policy Scenario (FPS); (2) a trend-constrained pathway, and (3) a 1.5°C aspirational discussion.[24] Part of the IPR's focuses on the impacts of a specific set of forecasts on equity markets, finding that abrupt policies could wipe between 3.1% and 4.5%, or $1.6 trillion to $2.3 trillion off the valuation of a range of companies in the MSCI ACWI index.[25] One in five companies are impacted by at least 10% in either direction; the impact is equivalent to the largest 12 to 33 companies on the FTSE100.

Other key sectoral findings include:

- The 100 worst performing companies in the MSCI ACWI lose 43% of their current value, equivalent to $1.4 trillion, while the 100 best performers would gain 33% of current value, equivalent to $0.7 trillion.
- Automakers with the highest investments in EVs could see their value increase by 108%.
- The world's largest listed coal companies could halve in value (down 44%).

media/documents/climate-change-resilience.pdf; *see also* Exxon 2019 Energy & Carbon Summary (June 2017) ("In addition, this year's report is further enhanced by aligning with the core elements of the TCFD framework") available at: https://corporate.exxonmobil.com/-/media/Global/Files/energy-and-carbon-summary/2019-Energy-and-Carbon-Summary_archive.pdf.

[22] Securities & Exchange Commission, Statement of Chairman Jay Clayton, *Proposed Amendments to Modernize and Enhance Financial Disclosures; Other Ongoing Disclosure Modernization Initiatives; Impact of the Coronavirus; Environmental and Climate-Related Disclosure* (Jan. 30, 2020).

[23] The PRI, *What is the Inevitable Policy Response*, available at: https://www.unpri.org/inevitable-policy-response/what-is-the-inevitable-policy-response/4787.article.

[24] The PRI, *Inevitable Policy Response: Policy Forecasts,* available at: https://www.unpri.org/download?ac=9832.

[25] The PRI, *Inevitable Policy Response: Equity Markets Impacts,* available at: https://www.unpri.org/inevitable-policy-response/forecast-policy-scenario-equity-markets-impacts/5191.article.

- The ten largest companies in the integrated oil & gas exploration & production sector by market cap lose nearly a third (31%) of current value, or $0.5 trillion.
- Miners producing minerals critical for the transition see a 54% upside, while those with the smallest share of "green minerals" see valuations halve (down 49%).
- Agricultural companies with high exposure to sustainable biofuels and production of non-beef protein sources, for which demand is growing, experience gains of at least 10% of current value. Those companies heavily exposed to sectors in decline, such as cattle, lose more than -15%, with exposure increasing to as much as negative 43% for companies directly associated with deforestation owing to additional legal liabilities, loss of market access, and consumer pressure.
- For downstream food and beverage companies, emerging data about supply chain exposure to deforestation suggests that the potential value loss from these compounded risks could be up to -15%.

In short, the longer the delay in action from policymakers on climate change, the greater the severity of impact on financial markets and investors' portfolios—and the more costly these risks will be to mitigate.

From late September 2020, the PRI will be publishing detailed modelling of the impact on the macroeconomy; key sectors, regions, and asset classes; and on the world's most valuable companies. The PRI encourages the SEC to review the materials cited herein about the need for investors to start considering a range of policy responses to climate change in their risk assessments.

CONCLUSION

The PRI agrees with the Commission's assessment that Regulation S-K should be modernized and updated. We are encouraged by Chairman Clayton's and the Commission's interest in hearing from market participants these issues. However, the PRI is concerned about the SEC's failure to adequately quantify the costs and benefits of the proposed new principles-based disclosures in the MD&A of annual securities disclosures and its failure to include climate-risk disclosure as part of its disclosure modernization effort. Accordingly, the PRI recommends that: (1) the SEC revise the Proposed Rule's economic analysis to empirically measure the costs and benefits of the proposed principles-based disclosures; and (2) climate-related disclosures be included as part of the Commission's modernization effort under Regulation S-K. Now more than ever, mandatory, high-quality disclosure will be vital for investors to manage portfolio risks, whether in a pandemic or with climate change.

Finally, the PRI hopes its ongoing detailed quantitative assessment of portfolio risks investors face as a result of abrupt policy shifts in response to climate change will be useful to the Commission as it learns more about how investors are assessing climate change risks.

Thank you for the opportunity to share our views. For further conversation and follow up, please feel free to contact our policy team:

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Yours sincerely,

Fiona Reynolds
Chief Executive Officer
Principles for Responsible Investment

cc. The Honorable Jay Clayton, Chairman
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner
The Honorable Allison H. Lee, Commissioner