Frederick H. Alexander
[redacted]

June 17, 2022

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

RE: File No. S7-10-22

Dear Ms. Countryman:

We are writing in response to S7-10-22, "The Enhancement and Standardization of Climate-Related Disclosures for Investors" (the "Proposed Rules").

The Shareholder Commons (TSC) is a nonprofit advocate for diversified investors. B Lab U.S. & Canada is one of six global partners in the B Lab global network. B Lab U.S. & Canada works to foster and mobilize a growing community of people and businesses working toward a more fair and inclusive economy in the United States and Canada.

A. Introduction

We submit this letter in response to the Securities and Exchange Commission's (the "Commission") request for comment on the Proposed Rules and the accompanying release proposing amendments to its rules under the Securities and Exchange Act (the "Release"). The Proposed Rules would require companies to make certain climate-related information publicly available, including climate-related risks that are reasonably likely to have a material impact on a company's business, results of operations, or financial condition. The required information about climate-related risks would include disclosure of a company's greenhouse gas (GHG) emissions, a commonly used metric to assess such risks.

We submit this comment in support of the Proposed Rules. More specifically, we write to emphasize that the Commission's mission is to protect investors, and that the information the Proposed Rule requires would protect investors by providing material information not only about climate-related risks to individual companies, but also about risks that a company's climate-related activities pose to social, environmental, and financial systems and, consequently, to other companies in investors' diversified

A: PO Box 7545 | Wilmington, DE 19803 | USA [redacted]

portfolios.[1] To further the Commission's investor protection mission, we also recommend that the Proposed Rules be modified to require Scope 3 emissions disclosure and other information if it is material to diversified investors, even if not material to the company's own financial performance.

B. Two levels of risk: alpha and beta

Companies' climate-related activities create risk for investors at two levels. First, a company's GHG emissions or other activities may threaten its own financial performance relative to other companies ("alpha"); this is the type of risk contemplated by the materiality test described in Section II.B.2 of the Release. The second level of risk, which the Proposed Rules do not explicitly address, is systemic, i.e., risks to environmental systems that implicate the markets as a whole, chiefly by threatening the performance of the global economy ("beta.") [2]

As we discuss in Parts E and F below, systemic risk to beta presents the greatest threat to long-term, diversified shareholders' portfolios and climate change is a critically important systemic risk. These investors need information about the risks GHG emissions and other climate-related business activity pose to environmental, social, and financial systems. The Proposed Rules will provide such information, but could be improved to provide Scope 3 emissions disclosure and other information relevant to beta.

C. Security selection v. stewardship

In addition to the two levels of investment risk, there are two primary methods by which investors can seek to mitigate them. The first, which addresses alpha-level risk, involves choosing securities that effectively mitigate the risk that companies will underperform the market due to their climate-related activities: for example, if an investor believes that a certain security will underperform because of its GHG emissions, that security can be avoided or underweighted in a portfolio, or other securities can be purchased that pose non-correlated risks, thereby hedging the alpha risk ("security selection"). A climate-related example of security selection to reduce such risk would be divesting or underweighting companies that emit large amounts of GHG to address concern that such businesses will eventually be subject to additional costs through regulatory, tax, reputational, or other channels.

Alternatively, investors can seek to mitigate climate-related risk by using their rights as investors to change company behavior ("stewardship.") A climate-related example of stewardship would be last year's campaign by Exxon Mobil shareholders to replace some of the directors with directors more likely to

---

[1] *See* Comment on the Proposed Rule submitted by Jon Lukomnik and Keith Johnson ("systemic risks to the environmental, social or financial systems, or to the capital markets which are created by an issuer – such as those contemplated in the SEC's proposed rules on climate reporting – are material to the reasonable investor.")

[2] "Beta" in this sense differs from the formal use of the term in the financial literature, where it refers to the specific risk of a security or securities not attributable to the market. More recently, literature addressing the importance of broad market returns to diversified investors has used the term to refer to the overall return of the market, in contrast to alpha, which is the performance of a particular security or portfolio in comparison to overall market return. *See, e.g.,* Jon Lukomnik & James P. Hawley, *Moving beyond Modern Portfolio Theory: Investing that Matters* (2021).

address the company's capital allocation to continued fossil fuel investment. This campaign's explicit aim was to address the risk this allocation strategy posed to Exxon Mobil's performance.[3]

In contrast to the Exxon Mobil campaign's express purposes, investors might vote or exercise other corporate governance rights to mitigate the risk a portfolio company's GHG emissions or other actions posed to the economy as a whole. Shareholder advocacy organization Majority Action's "Proxy Voting for a 1.5°C World" campaign exemplifies this strategy, which it describes as follows:

> *In 2021, Majority Action issued company-specific director vote guidance at 19 U.S. oil and gas, electric power, and financial services companies that were demonstrably out of alignment with limiting warming to 1.5°C.*[4]

Majority Action explains that shareholders should support its stewardship campaign to mitigate risk across their portfolios, rather than as a matter of managing specific risks to individual companies:

> ***The physical and financial risks posed by climate change to long-term investors are systemic, portfolio-wide, unhedgeable, and undiversifiable.*** *Therefore, the actions of companies that directly or indirectly impact climate outcomes pose risks to the financial system as a whole and to investors' entire portfolios. In order to manage this systemic portfolio risk, investors must move beyond disclosure and company-specific climate risk management frameworks and focus on holding accountable the relatively small number of large companies whose actions are a significant driver of climate change.*[5]

Mandatory disclosure of GHG emissions and other beta-relevant data would give investors accurate, comparable information about the climate impact of companies in their portfolios, enhancing their ability to use their governance rights to "manage this systemic portfolio risk," thereby protecting investors from the threat of a warming planet.

D. Pathways for mitigating climate risk

Table 1 matches the two levels of risk with the two strategies for mitigation. It also addresses how each possible combination of strategy and value perspective can address both *physical risks* (risks that a changing climate presents to financial performance) and *transition risk* (risk that the expected decarbonization of the economy poses to financial performance).

---

[3] It is also possible that some supportive investors believed that the continued investment by a major petroleum exploration company in new fossil fuel projects posed a threat to beta as well, by making it more likely that GHG emissions would lead to a level of warming that threatened the global economy.
[4] https://www.proxyvoting.majorityaction.us/
[5] *Id.*

Table 1

	ALPHA: RISKS TO THE RELATIVE PERFORMANCE OF INDIVIDUAL COMPANIES IN A PORTFOLIO	BETA: RISKS TO THE ECONOMY THAT WILL BE FELT ACROSS THE PORTFOLIO
SECURITY SELECTION	Security selection to address company-specific risks involves avoiding companies that are more exposed to physical or transition risk and choosing companies with less such exposure.	Security selection on the secondary markets is generally not an appropriate method for addressing physical or transition risks that climate change imposes on the economy, because other owners may permit the company to continue its practices. Such divestment strategies can be counterproductive, leaving the control of large GHG-emitting companies in the hands of owners not concerned with climate risk. Denying companies new funding, however, can address beta concerns by raising the cost of capital.
STEWARDSHIP	Voting and engaging with individual companies can induce them to address both physical and transition risks that threaten the company's relative financial performance.	**Shareholders can engage and vote their shares to push companies to mitigate their contributions to systemic climate risk. This may mean ending practices that, even if optimal for the company, threaten the economy and thus overall market returns.**

The left two quadrants imply a need for climate-related disclosure that addresses risks to individual company relative performance. Investors can use such information to protect themselves from risks to individual companies' enterprise value through both security selection and stewardship.

The right two quadrants relate to the need for climate-related disclosure that allows investors to address overall market risks, particularly through stewardship. We discussed this at length in a prior comment letter regarding a proposed rule, *Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers.*[6] Critically, the chart illustrates that the primary tool investors have for mitigating climate risk to beta is stewardship, demonstrating that information that will empower investors to engage in beta stewardship is critical to investor protection. We address the centrality of beta stewardship in the following section.

[6] https://www.sec.gov/comments/s7-11-21/s71121-20109413-263829.pdf

E. The importance of beta stewardship to protecting diversified shareholders

In the prior comment,[7] we demonstrated that the relationship between GDP, social and environmental systems, and market returns means systemic threats to diversified investors cannot be avoided simply by picking stocks that will outperform the market when the failure of climate and other systems undermines the economy. The comment showed that beta is the most important factor in determining financial returns for long-term, diversified investors, who compose most of the economic beneficiaries of the U.S. equity markets and for whom more than 75 percent of return is determined by market returns.[8] Diversified investors cannot avoid certain common risks almost all companies face. These are the risks to the environmental, social, and financial systems in which the economy is embedded, including the climate system. One recent work explained that these system-wide risks inevitably "swamp" any alpha strategy:

> *It is not that alpha does not matter to an investor (although investors only want positive alpha, which is impossible on a total market basis), but that the impact of the market return driven by systematic risk swamps virtually any possible scenario created by skillful analysis or trading or portfolio construction.*[9]

A new report from the international law firm Freshfields Bruckhaus Deringer explains how the reality of systemic risk reverberates in investment trustees' fiduciary duty across jurisdictions and how diversification is insufficient to meet the challenge:

> *In recent years investors have increasingly focused on what must be done to protect the value of their portfolios from system-wide risks created by the declining sustainability of various aspects of the natural or social environment. System-wide risks are the sort of risks that cannot be mitigated simply by diversifying the investments in a portfolio. They threaten the functioning of the economic, financial and wider systems on which investment performance relies. If risks of this sort materialised, they would therefore damage the performance of a portfolio as a whole and all*

---

[7] *See supra*, n.6.
[8] *See also* Lukomnik and Johnson, *supra*, n.1 ("by 2017, approximately 80% of the United States equity market was institutional. Individuals, whether investing through their pension funds, mutual funds, ETFs or other intermediated accounts, now invest through diversified products. As a result, the typical investor is more concerned about the overall market than any one individual security. That makes sense. More than 75% of the variability in their return is caused by the non-diversifiable systematic risk of the market.") (citing Charles McGrath, "80% of equity market cap held by institutions", *Pensions & Investments,* April 25, 2017 and Lukomnik and Hawley, n.2, *supra).*
[9] *See supra,* n.2, Chapter 5 (emphasis added).

portfolios exposed to those systems.[10]

F. Climate change as beta risk

Climate change represents the quintessential beta risk. A 2021 report by Swiss Re, the world's largest reinsurer, examined likely temperature scenarios and estimated the impact of those scenarios on GDP as of 2050.[11] Working with current country-by-country climate mitigation pledges, they determined that warming by 2050 was likely to be 2.0-2.6°C, with 3.2°C as a severe but potential trajectory. They also concluded that action could still be taken to limit warming in that time frame to well below 2.0°C, an outcome that many have concluded is the upper limit to prevent a critical level of economic damage. Swiss Re estimated that the latter trajectory, which would mean crossing the 1.5°C threshold by mid-century, would result in a 4.2 percent GDP loss compared to no climate change (0°C of warming), while a 2.0°C trajectory would lead to an 11 percent GDP decline. On the higher end, Swiss Re estimated losses of 13.9 percent would be realized by 2050 at 2.6°C and, using the most severe but still possible scenario of 3.2°C, losses to GDP would reach 18.1 percent globally.

These potential GDP differentials are critical to diversified investors: as established in the ground-breaking study, *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors,* the value of a diversified portfolio of equities is directly proportional to GDP.[12] Thus, the reductions in GDP described in the Swiss Re report imply trends toward similar reductions in equity portfolio value over time. This relationship holds because common equity represents a right to future cash flows from companies, so that ownership of a portfolio of equities represents the right to the future cash flows of the proportion of the economy that those shares represent. Of course, the multiples at which shares trade may rise and fall, but over the long term, the relationship between portfolio price and GDP is linear.[13] Moreover, the climate trajectory can be changed only by changing the way business operates. In the United States, for example, 87 percent of total GHG emissions come from the transportation, electricity generation, industrial, and agricultural sectors,[14] all heavily driven by investor-owned companies' decisions.

---

[10] *A Legal Framework for Impact: Sustainability Impact in Investor Decision-Making* (2021). The report, which ran to 558 pages, studied the law of jurisdictions significant to global capital markets, including the United States, and the conclusions cited in this comment letter extend to U.S. trustee law.

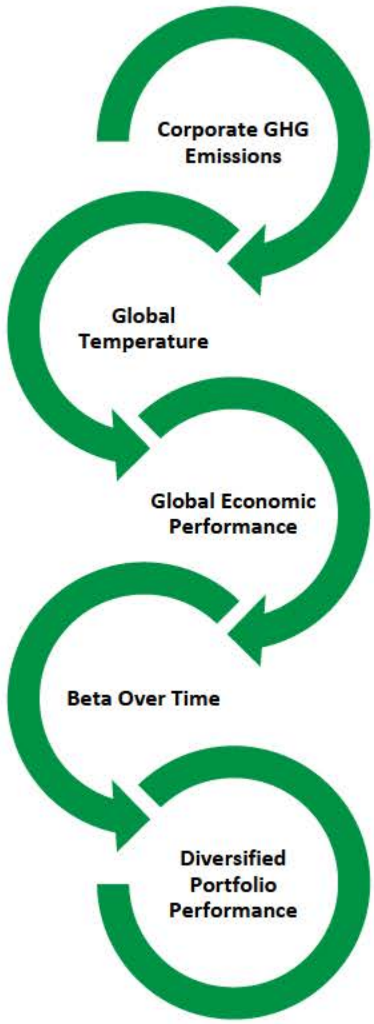
[11] *The Economics Of Climate Change: No Action Not An Option* (2021) https://www.swissre.com/dam/jcr:e73ee7c3-7f83-4c17-a2b8-8ef23a8d3312/swiss-re-institute-expertise-publication-economics-of-climate-change.pdf, Pg. 28-30

[12] PRI, *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors* (2011), available at https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf

[13] *Id.* ("the relationship between GDP and the price of the portfolio of a [long-term, diversified investor] is linear in the long term.") The cited work extends only to the equity portion of an investor's portfolio, but because its premise is the observation that the value of companies equals the value of their future cash flows, we believe that its logic should extend to the debt portion of portfolios as well, because the total return on companies financed with outside capital is equal to the combined cash flows to both debt and equity. Accordingly, an investor's entire debt and equity portfolio, not just the latter, should move together with the value investable universe those companies compose. This reinforces the importance to investors of using their influence to ensure that companies do not degrade broad economic value.

[14] U.S. Environmental Protection Agency, Sources of Greenhouse Gas Emissions, available at https://www.epa.gov/ghgemissions/sources-greenhouse-gas-emissions

In short, the greatest financial risk to the investors whom the Commission is charged with protecting comes from companies emitting GHG to an extent that puts the entire economy at risk. This chart illustrates the relationships creating this connection:



The information the Proposed Rules call for will assist shareholders in negotiating these relationships, empowering them to protect themselves from company decisions that may benefit individual company financial performance but threaten their owners' diversified portfolios.

G. Response to Questions 8 and 98

Questions 8 and 98 ask:

8. Should we require a registrant to disclose any climate-related risks that are reasonably likely to have a material impact on the registrant, including on its business or consolidated financial statements, which may manifest over the short, medium, and long term, as proposed? …

98. Should we require a registrant to disclose its Scope 3 emissions for the fiscal year if material, as proposed? Should we instead require the disclosure of Scope 3 emissions for all registrants, regardless of materiality? Should we use a quantitative threshold, such as a percentage of total GHG emissions (e.g., 25%, 40%, 50%) to require the disclosure of Scope 3 emissions? If so, is there any data supporting the use of a particular percentage threshold? Should we require registrants in particular industries, for which Scope 3 emissions are a high percentage of total GHG emissions, to disclose Scope 3 emissions?

These two questions reflect the focus of the Proposed Rules and the Release on risk to individual companies. We support the current Proposed Rules both because the information provided will inform investors with respect to company-specific risks (as indicated in the Release) and because that information is likely to be useful in assessing the risk individual company behavior poses to beta. However, we believe the Proposed Rules would serve investors better if the final rule specifically addressed systemic risk. We recommend two changes to provide such clarification.

First, the Proposed Rules should be altered so that Scope 3 emissions must be disclosed if material to (1) company financial performance **or (2) the returns of diversified portfolios.** Second, Item 1502 should be reworded specifically to contemplate **risks that climate-related activity poses to diversified portfolio returns.**

Addition of such language will ensure that the final rule will equip diversified investors with the knowledge necessary to steward companies away from the emissions and other behaviors that threaten investment portfolios. For these purposes, the final rules should clarify that the activities (including emissions) of a single company can be material not just through the direct contribution of those activities to warming, but also through contribution to a competitive dynamic in which companies competing for margin and capital are more likely, as a group, to engage in climate-related activities at a level that will be materially harmful to diversified portfolios.

* * * *

For all the reasons expressed and in the manner described in this letter, we urge the Commission to adopt final rules that provide investors with information that addresses the effect companies in their portfolios have on climate change to the extent such activities affect their diversified portfolios' overall financial performance.

Sincerely,

Frederick Alexander
Chief Executive Officer
The Shareholder Commons

Holly Ensign-Barstow
Director of Stakeholder Governance and Policy
B Lab US/CAN