Testimony of

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"Climate Change and Social Responsibility: Helping Corporate Boards and Investors Make Decisions for a Sustainable World"

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Chairman Sherman, Ranking Member Huizenga, and other Members of the Subcommittee:

Thank you for the opportunity to testify at today's hearing. My name is James Andrus, and I am an Investment Manager for the Board Governance and Sustainability program for the California Public Employees' Retirement System ("CalPERS"). I am pleased to appear before you today on behalf of CalPERS. We applaud and support the Subcommittee's focus on building a sustainable and competitive economy.

I will provide an overview of CalPERS, discuss our governing principles, and discuss critical areas in which more disclosures by public issuers are necessary: climate risk, charitable and political expenditures, human capital management, and board diversity. My testimony discusses how a system that ensures effective, accountable and transparent corporate governance is critical to capital formation with the objective of achieving the best returns and value for shareowners over the long-term. Ultimately, CalPERS's primary responsibility is to our beneficiaries, so our long-term investment returns are central to our views on what information we need to make the right investment choices.

CalPERS

CalPERS is the largest public pension fund in the United States ("U.S."), with approximately $450 billion in global assets and equity holdings in over 10,000 public companies globally. CalPERS is a fiduciary that provides nearly $25.8 billion annually in retirement benefits to more than 2 million members. Delivering investment returns is our investment office's number one job. Nearly 55 cents of every dollar paid in those benefits comes from investment returns. Moreover, achieving good investment returns helps us avoid increasing the contributions required from California's communities. Increasing contributions takes away budget resources otherwise available for those communities to provide public services. This means that our members depend upon safety and soundness in the capital markets for their retirement security. For these reasons, we are focused on sustainability issues that drive risk and return to our portfolio.

To promote long-term returns, our Board has adopted Investment Beliefs,[1] which recognize the importance of today's hearings for long-term fiduciaries. CalPERS is guided by its fiduciary duties of prudence, care and loyalty. We ensure full compliance with all laws and regulations provided by government and regulators. Investment Belief Four states: "Long-term value creation requires effective management of three forms of capital: financial, physical and human." Investment Belief Nine demands that we focus on multi-faceted risks. Therefore, CalPERS engages companies and managers on their management of climate change risks and human capital practices, including fair labor practices, health and safety, responsible contracting and diversity.

[1] CalPERS Investment Beliefs, available at https://www.calpers.ca.gov/docs/board-agendas/201702/pension/item7-01.pdf.

CalPERS has developed and implemented a set of Governance and Sustainability Principles ("Principles").[2] These Principles are a statement of our views on best practices to guide the internal and external managers of CalPERS when making investment decisions and provide the framework by which we advocate with policy-makers, execute our shareowner proxy voting responsibilities, and engage portfolio companies to achieve long-term returns.

CalPERS' Sustainable Investment Strategic Plan and Principles

In August of 2016, the CalPERS Board of Administration adopted a five-year Sustainable Investment Strategic Plan ("Strategic Plan") for the purpose of minimizing risk, maximizing returns, and ensuring accountability from all those involved. Within this broad framework, my testimony will highlight CalPERS' views on data and corporate reporting, among other topics central to the sustainability disclosure dialogue. Together, our Investment Beliefs, Principles, and Strategic Plan support advocating for a robust reporting regime for publicly traded companies that would address issues that impact shareowner value over the long-term. Together, they have guided us to work with partners and advocate for policies that address disclosures regarding climate-related risk, charitable and political expenditures, improvements in human capital management, and board diversity, among other issues. I applaud this Subcommittee for focusing on certain matters that we consider critical to a sustainable economy.

It is important to note that the discussion today focuses substantially on disclosures provided by publicly traded companies. For the past few years, the majority of capital raised in the U.S. has not been generated through public offerings.[3] To the contrary, the majority of capital raised in the U.S. is now often through "private" offerings, which do not have the disclosure obligations, investor rights, or other protections that are the hallmarks of efficient public capital markets. Transparency and shareowner rights are essential to promoting corporate and executive accountability. For that reason, we and other fiduciaries remain committed to promoting a robust public market.

As a fiduciary focused on maximizing our returns for our beneficiaries, we have had to explore more opportunities in private markets. In order to address sustainability issues in the private markets we (1) have adopted a responsible contractor policy for human capital management in real assets; (2) use the GRESB framework for real assets and infrastructure which collects data from our private market asset managers on sustainability issues; and (3) use ILPA's model templates for including ESG and diversity and inclusion in manager due diligence. Furthermore, our strategic plan includes Sustainable Investment Practice Guidelines[4] which each asset class for both public

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[2] https://www.calpers.ca.gov/docs/forms-publications/governance-and-sustainability-principles.pdf.

[3] We note that recently, there has been an unprecedented uptick in public offerings in what are essentially "blank check" companies, often called Special Purpose Acquisition Companies (SPACs). We do not believe the current capital explosion in the number and dollars raised in those offerings is likely to be sustainable.

[4] https://www.calpers.ca.gov/docs/global-equity-sustainable-investment-guidelines.pdf;
https://www.calpers.ca.gov/docs/real-assets-sustainable-investment-guidelines.pdf

and private markets sets out how they identify and integrate these issues into decisions. Despite the generally greater risks and costs of these private investments, we cannot simply ignore the market where more than half of new investments are made.

This changing dynamic raises an important point for today's discussion: most of the sustainability-related policy dialogue focuses only on the public markets. This was a point raised by BlackRock's CEO, Larry Fink, recently,[5] and I will reiterate it here: policy-makers and regulators must address corporate and executive accountability for sustainability choices in both the public and the private markets. This may require revisions to some of the exemptions and exceptions to the federal securities laws that have given rise to much of the recent private market expansion, but it may also entail enhancing information and rights for long-term stakeholders in the private markets as well.

More Useful Disclosures for More Efficient Capital Markets

The U.S. is home to the world's most dynamic and robust capital markets. As a significant institutional investor with a long-term investment horizon, CalPERS fundamentally depends on the integrity and efficiency of our financial markets to provide the sustainable, risk-adjusted returns that allow us to meet our commitments over the course of multiple decades. Disclosure of important information is essential to maintaining the integrity and efficiency of our financial markets, and it is a pre-condition to sound investment, effective and consistent corporate accountability, and sustainable economic growth. As the Securities and Exchange Commission ("SEC") has said in the past: "Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions. The result of this information flow is a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation's economy."[6]

Our Principles outline opportunities to strengthen effective disclosures and guide our advocacy efforts. We believe strongly that all investors, whether large institutions or private individuals, should have access to comprehensive, high-quality, consistent, and comparable disclosures that enable them to make informed decisions whether to buy, sell, or hold certain securities, and how to vote their shares. Without this vital information, CalPERS and other investors are disadvantaged as we make capital allocation decisions and assess the performance of corporate boards and management teams. Put simply, we and other investors make better decisions when we have better information. That is not just better for our beneficiaries, but that is also better for the companies in which we invest and the economy overall. CalPERS and other pension funds are inhibited from adequately exercising their fiduciary duty without comprehensive, high-quality, consistent, and comparable disclosures.

[5] https://www.brookings.edu/wp-content/uploads/2021/02/es_20210202_climate_blackrock_transcript.pdf.
[6] U.S. Securities & Exchange Commission, What We Do, available at https://www.sec.gov/Article/whatwedo.html.

Importantly, the U.S. disclosure regime currently places essentially all discretion in the hands of the issuer to determine whether and how to disclose most sustainability information. Requiring standardized disclosures of relevant information is necessary to close the information gap that occurs when management of a company is aware or should be aware of certain risks, yet such information is not made available to shareowners by management. Reducing the discretion of corporate executives to determine whether and how to provide disclosures would greatly promote consistency and accountability. In line with this view, we strongly support a further comprehensive review of the disclosure requirements of Regulation S-X and Regulation S-K with a greater focus on what investors want and have actively responded to the relevant requests for comment in support of greater transparency.[7]

Indeed, there are many substantive areas about which long-term investors could use more reliable information. In particular, comprehensive, high-quality, consistent, and comparable disclosures of climate risk, charitable and political expenditures, human capital management, and board diversity are critical to the long-term success of capital markets, and more critically, of investors. Disclosures of such information will help investors allocate capital to companies that best meet their investment criteria and will encourage market participants to operate with an eye on long-term business strategy. Such disclosures will also encourage companies to be more mindful of these risks that could impact their operations, and will provide for greater transparency regarding cash flow, corporate expenditures, and public policy engagement.

I will now discuss, in broad terms, CalPERS' views on these topics.

Climate Risk Disclosures

CalPERS has carefully monitored material climate risks that its portfolio companies face and engaged directly with those companies about their efforts to mitigate such risks over many years. Since December 2019, we have considered climate-related risks to be among the top three risks to the long-term value of our portfolio. Our view aligns with the U.S. National Climate Assessment's finding that "[c]limate change exacerbates existing vulnerabilities in communities across the United States, presenting growing challenges to human health and safety, quality of life, and the rate of economic growth."[8]

Accordingly, we help lead global initiatives to develop more effective reporting frameworks so that climate risks can be accounted for comprehensively and work with companies to address

[7] *See* Letter from CalPERS to Brian J. Fields, Secretary, U.S. Securities and Exchange Commission (Nov. 30, 2015) (available at https://www.sec.gov/comments/s7-20-15/s72015-38.pdf); Letter from CalPERS to Brian J. Fields, Secretary, U.S. Securities and Exchange Commission (July 21, 2016) (available at https://www.sec.gov/comments/s7-06-16/s70616-267.pdf).

[8] Fourth National Climate Assessment, Volume II: Impacts, Risk, and Adaptations in the United States, U.S. Global Change Research Program (2017), https://nca2018.globalchange.gov/.

climate-related risk. Such initiatives help make our financial system more resilient and prosperous for the long-term. For instance, Climate Action 100+ is an initiative which CalPERS co-founded to engage the systemically important carbon emitters. Investors with close to $50 trillion support the initiative. Half of these 100 "systemically important carbon emitters" have set goals to achieve net zero targets in line with the Paris Agreement. Such engagement, while constructive and important to mitigating climate-related risk in financial markets, is not a panacea and does not systematically address the critical information gap between investors and issuers on systemic risk of climate change. The better approach would involve having the relevant regulators address the issues instead of forcing shareowners to attempt to close the information gap.

Climate change is a systemic risk, so it is critical that investors can access clear disclosures of the risks it poses to long-term value creation by the companies in which they invest. Embedded in our Principles is the expectation that corporate boards have companies disclose fair, accurate, and material information relevant to investment decisions, thereby enabling shareowners to evaluate risks, past and present performance, and to draw inferences regarding future performance. For investors navigating the complexity of climate change risk, it is essential to have detailed scenario-based corporate disclosures regarding the potential impact of both the transition and physical risks to corporations' performance across time horizons (short, medium and long-term). This information helps investors properly evaluate potential return on investment and to make informed comparisons among investment opportunities.

Comprehensive disclosure of risk factors related to climate change should clearly reveal how companies identify and manage such risks to generate sustainable economic returns. Investors need companies to provide a detailed explanation of how each significant climate-related risk affects the company, as well as disclosure of exactly how the company plans to address and manage the risk, so they can evaluate the risk-reward of their investments. Moreover, for investors, as the providers of the capital, knowing what measures the board of directors is taking to manage and mitigate risks creates trust and confidence regarding their investments. This information and confidence are critical for pension funds such as CalPERS to generate the returns we need over the long-term.

It is notable that the International Accounting Standards Board has issued guidance that promotes including certain climate risk items in financial statements.[9] This is an important development and one U.S. policymakers should consider thoughtfully. Ensuring that climate risk is properly portrayed in financial statements is vital to maintaining our efficient and vibrant capital markets and to the long-term success of investors as well as issuers.

[9] SEC Commissioner Allison Herren Lee, Playing the Long Game: The Intersection of Climate Change Risk and Financial Regulation (November 5, 2020).

Charitable and Political Expenditures Disclosures

Our Principles call for robust board oversight and disclosure of corporate charitable and political activity to ensure alignment with business strategy and to protect assets on behalf of shareowners. As a fiduciary, we need to know how our capital is being used, including if and when political expenditures are made. We have consistently been in favor of enhanced disclosure of such spending. In fact, for the last several proxy seasons, we have supported various shareowner proposals that would require companies to report their political spending and to adopt board oversight procedures.

Shareowner proposals seeking disclosure of corporate political activity, both lobbying and election spending, are one of the most frequently filed proposals every year: 93 were filed at public companies in 2019.[10] In part due to efforts by CalPERS and others, 292 companies are disclosing some or all of their political spending with corporate funds.[11]

The materiality of corporate political spending has recently been re-confirmed by companies themselves in the aftermath of the January 6th attack on the U.S. Capitol Building. Many companies in which CalPERS is invested released public statements regarding their political activities.[12] For example, Walmart,[13] Alphabet, Bank of America,[14] Citigroup, Coca Cola, Duke Energy, General Motors, JPMorgan Chase,[15] Schwab, Union Pacific, and UPS, said they would at least temporarily suspend all of their corporate political spending. Others, including Amazon, American Express, AT&T, Blue Cross Blue Shield, Disney, Dow, Goldman Sachs, Hallmark, MasterCard, and Morgan Stanley noted that they would suspend donations to the Members of Congress who voted against congressional certification of various states' electoral votes in the 2020 presidential election. We applaud these companies for recognizing the materiality of their political spending activities, and voluntarily disclosing their expenditures.

Investors should have the information necessary to decide for themselves how these types of expenditures affect the risk-return profile of investments in such companies. We agree with former Justice Anthony Kennedy's view in *Citizens United v. the Federal Elections Commission* that disclosure of corporations' political activity provides investors the transparency necessary to make informed decisions:

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[10] https://www.proxypreview.org/2019/report/social-issues/corporate-political-activity.

[11] https://politicalaccountability.net/impact.

[12] Alyssa Fowers, Chris Alcantara and Jena McGregor, *Companies are halting PAC contributions after U.S. Capitol riots. Here's where their money went*, Washington Post, Jan 15, 2021, *available at* https://www.washingtonpost.com/graphics/2021/business/pac-donations-capitol-riots/.

[13] https://www.reuters.com/article/us-usa-election-corporate-walmart/walmart-disney-suspend-contributions-to-u-s-lawmakers-who-opposed-biden-certification-idUSKBN29H2TO.

[14] https://www.wsoctv.com/news/local/major-charlotte-companies-reevaluating-political-donations-after-insurrection/RJBWWKCDM5CMRH7B2XOUVGO4WQ/.

[15] https://www.bloomberg.com/news/articles/2021-01-11/wall-streets-cuts-campaign-spending-to-condemn-u-s-politicians.

> With the advent of the Internet, prompt disclosure of expenditures can provide shareholders and citizens with the information needed to hold corporations and elected officials accountable for their positions and supporters. Shareholders can determine whether their corporation's political speech advances the corporation's interest in making profits, and citizens can see whether elected officials are "'in the pocket' of so-called moneyed interests." [] The First Amendment protects political speech; and disclosure permits citizens and shareholders to react to the speech of corporate entities in a proper way. This transparency enables the electorate to make informed decisions and give proper weight to different speakers and messages.[16]

I highlight Justice Kennedy's words because they make clear that the Supreme Court envisioned future action by Congress to enhance transparency with respect to corporate political expenditures. We agree and urge Congress or the SEC to implement these important disclosures.

Human Capital Management Disclosures

The convergence of the current economic, climate, and public health crises, as well as the mounting call to advance racial equity have accelerated investors' focus on effectively managing human capital. We share this focus. In fact, it has long been one of our core investment beliefs that "long-term value creation requires effective management of three forms of capital: financial, physical and **human**" (emphasis added). Accordingly, as outlined in our Principles, "we expect, fair, accurate, timely, and assured reporting on how companies employ financial, physical, and human capital to generate sustainable returns, as well as how they identify, monitor, and mitigate risks to those three forms of capital."

The value of human capital management disclosures is straightforward: businesses depend on the workforce as a source of value creation which, if mismanaged, could harm long-term performance. The size, scale and viability of a company's operations directly affect the scope of potential human capital risks. Recognition of the positive correlation of human capital to value creation continues to build amidst growing research.[17] A research study on "The financial case for human capital disclosure by firms" by Dr. Anthony Hesketh, Lancaster University Management School, found a positive correlation between performance and disclosure of human capital data.[18] Additionally,

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[16] *Citizens United v. FEC*, 558 U.S. 310 (2010).
[17] Mark Huselid, The Impact of Human Resource Management Practices on Turnover, Productivity, and Corporate Financial Performance, 18 Academy of Management J. 635 (1995). See also Alex Edmans, Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices, 101 J. of Financial Economics 621 (2011).
[18] Intangible or Invisible? https://www.calpers.ca.gov/docs/board-agendas/202007/full/day1/03-pp-hcm_a.pdf.

other researchers have found that high quality human capital management practices correlate with lower employee turnover, higher productivity, and better corporate financial performance, producing a considerable and sustained alpha over time.[19] Disclosure of human capital management provides investors necessary transparency into material operations and risks.

Despite the value of human capital management and the importance to investors of understanding related risks, the current disclosure regime for corporate reporting is inadequate. Current financial reporting rules require companies to disclose very little information about how human capital is measured or managed. In addition, reporting varies by company and too often what is reported fails to reflect reality since reports investors receive from public companies are largely voluntary and often do not cover issues of relevance to capital allocators. The recent SEC rulemaking on human capital disclosures was non-prescriptive and did not go far enough to address the information gap between what company managers know and what is revealed to investors.[20] We cannot ignore the evidence that 85 percent of the S&P 500 balance sheet is intangible assets, such as human capital. Therefore, current financial reporting is insufficient as it only covers 15 percent of the balance sheet.

The need for public companies to disclose better information so that shareowners can more easily identify, assess, and manage risk and opportunity has been brought to the SEC's attention over the last several years. For instance, the SEC Investor Advisory Committee (IAC) made recommendations on Human Capital Management Disclosure on March 28, 2019. The IAC's recommendations include disclosing (1) employees on the basis of full-time, part-time, and contingent workers; (2) voluntary and involuntary turnover and internal hire and promotion rates; and (3) the safety of the workforce, including frequency, severity and lost-time due to injuries, illnesses and fatalities.[21] Last year, former SEC Chairman Jay Clayton reaffirmed the critical need for better human capital management disclosures, particularly around the health and well-being of a company's workforce.[22]

To improve human capital management disclosure requirements, we have long-advocated for more line-item disclosures. Such disclosures should include, in addition to the IAC's recommendations, workforce skills and capabilities, use of subcontracting and outsourcing, diversity, pay equity, and training, among others.

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[19] See Huselid and Edmans, *supra* note 6.
[20] https://www.sec.gov/rules/final/2020/33-10825.pdf.
[21] https://www.sec.gov/spotlight/investor-advisory-committee-2012/human-capital-disclosure-recommendation.pdf. The IAC also recommended disclosure of: average hours of training per employee per year, race/ethnicity and gender diversity data, and standardized survey measures of employee satisfaction.
[22] https://www.sec.gov/news/public-statement/statement-clayton-hinman (dated April 8, 2020).

CalPERS and other investors have asked Congress and the SEC to expand disclosures for investors in a number of issues relevant to risk and return, including human capital. It is vital that Congress and the SEC act.

Board Diversity Disclosures

Related to human capital management disclosures is the need for more transparency into board diversity. In Section B of our Principles, we emphasize the importance of board quality, including the need for board diversity:

> The board [of directors] should facilitate a process that ensures a thorough understanding of the diverse characteristics necessary to effectively oversee management's execution of a long-term business strategy. Board diversity should be thought of in terms of skill sets, gender, age, nationality, race, sexual orientation, gender identity, disability, and historically under-represented groups. Consideration should go beyond the traditional notion of diversity to include a broader range of experience, thoughts, perspectives, and competencies to help enable effective board leadership.

We believe that diversity helps companies improve their performance over the long-term because a multiplicity of backgrounds, experiences, and perspectives helps management address risk and seize opportunities in a more holistic manner. Our view is informed by research into the efficacy of a diverse board. For instance, the Office of the Illinois State Treasurer published a white paper titled "The Investment Case for Board Diversity" which provides an extensive and comprehensive review of academic and practitioner research on the value of gender and racial/ethnic board diversity for investors.[23] The examination finds that "the gender and racial/ethnic composition of corporate boards does indeed have a material and relevant impact on company performance and investors."

Unfortunately, there is a substantial lack of diversity at U.S. companies, especially outside of the S&P 500. Nasdaq has stated that the U.S. currently ranks 53rd in board gender diversity, according to the World Economic Forum.[24] Given the lack of disclosures about board diversity, it is hard to get very good data on racial diversity on boards, but third party analysis appears to show that as many as 70 percent of Nasdaq companies' boards are not diverse at all.[25] The SEC

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[23] THE INVESTMENT CASE FOR BOARD DIVERSITY: A Review of the Academic and Practitioner Research on the Value of Gender and Racial/Ethnic Board Diversity for Investors, Office of the Illinois State Treasurer (October 2020), https://illinoistreasurergovprod.blob.core.usgovcloudapi.net/twocms/media/doc/il%20treasurer%20white%20paper%20-%20the%20investment%20case%20for%20board%20diversity%20(oct%202020).pdf.

[24] Self-regulatory Organizations; The Nasdaq Stock Market LLC; Notice of Filing of Proposed Rule Change to Adopt Listing Rules Related to Board Diversity [Release No. 34-90574; File No. SR-NASDAQ-2020-081].

[25] Andrew Ross Sorkin, Jason Karaian, Michael J. de la Merced, Lauren Hirsch and Ephrat Livni, *Nasdaq Pushes for Diversity in the Boardroom.* https://www.nytimes.com/2020/12/01/business/dealbook/nasdaq-diversity-boards.html.

has taken up the discussion on a few occasions and has always fallen short of actually addressing diversity. Without more comprehensive disclosures of board diversity, we and other investors are less able to evaluate the competitive advantages between companies.

To remedy this information asymmetry, boards should annually disclose their demographic information including race, ethnicity, and gender. Ideally, companies should disclose their Employer Information Report, known as the EEO-1 report, or similar workforce demographic data to enable shareowners to assess the board's diversity relative to its workforce and compare companies in similar industries.

Conclusion

CalPERS is a fiduciary whose primary goal is making good investments to fulfill our responsibility to our members. We believe companies' long-term value creation requires effective identification and management of these types of risks and opportunities. In other words, we have a long history of focusing on these risk areas because of their potential effects on our returns and it is investors like CalPERS who ultimately bear the costs when these risks are not managed adequately nor disclosed timely.

Policy-makers have an important role to play in creating a regulatory framework that incentivizes the companies we invest in to employ sustainable business practices while generating returns that meet public pension funds' needs. Policies that encourage sustainable business practices and require disclosures that help investors identify companies that are able to both deliver the returns we need and have measurable positive social, environmental, and human capital impacts are useful in strengthening investor confidence and encouraging capital to flow toward a more sustainable economy.

We look forward to working with the Subcommittee and Committee to discuss these issues, as well as the policy proposals set forth in today's hearing, and hopefully more proposals in the future. Thank you, Chairman Sherman and Ranking Member Huizenga for inviting me to participate in this hearing, and I look forward to your questions.