

# The SEC Welcomes Climate Disclosures and Wrongdoing at Toshiba

*Featuring:*

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Mike Disabato:

What's up everyone and welcome to the weekly edition of ESG Now where we cover how the environment, our society and corporate governance affects and are affected by our economy. I'm your host, Mike Disabato and this week we have two stories for you. First, our global head of ESG research, Linda Ealing Lee joins us to discuss our comments to the SEC on their new proposal to update and expand the regulation on climate change disclosures. It's much more interesting than it sounds at first blush, I promise. And then we discuss government collusion and the class of corporate titans in Japan. Thanks as always for joining us. Stay tuned.

Mike Disabato:

It might be surprising to hear this but a majority of Americans, around 65% believe that the federal government falls short on its efforts to reduce the impacts of climate change. That's according to a survey conducted by the Pew Research organization in 2020 that includes both Democrats and Republicans, obviously. It's all Americans. It is a much different sentiment from 2010 when Pew did a similar poll and found that only 37% of Americans were seriously concerned about climate change. 2010 is a significant year because it was also when the SEC last address climate change disclosures for public companies. In their 2010 guidance, the SEC chairperson, Mary Shapiro stated, "we are not opining on whether the world's climate is changing, at what pace it might be changing or due to what causes. Nothing that the commission does today should be construed as weighing in on those topics but we are going to provide guidance that will help to ensure that our disclosure rules are consistently applied about climate change."

Mike Disabato:

Now, a lot has changed a decade hence with respect to what we know about climate change and the financial risks it creates for global markets and our species comfortable survival going forward. And the SEC for which all of you sane people out there that doesn't care about the SEC, the SEC is basically the regulatory system that makes the financial market work. The

SEC knows things have changed since 2010 as well so, it does put out a call to update those disclosures. And in March 15th 2021, the acting chair of the SEC Allison Herren Lee, who was succeeded recently by Gary Gensler, that actually happened in April, wrote that "In light of demand for climate change information and questions about whether current disclosures adequately inform investors, public input is requested from investors, registrant's and other market participants on climate change disclosure." The public input request consisted of 15 questions, all looking to standardize how companies worth trillions of dollars talk about and report on climate change.

Mike Disabato:

And we as an organization are actually part of those registrants that the SEC was asking information on and we have some opinions on climate so, I wanted to talk about our response to these climate disclosure requirements that have been put up by SEC. Because this week the comments were due and a lot of companies came out and talked about it. Microsoft and Walmart and the American Fuel, petrochemical manufacturers. And I know that this stuff seems drier than the American west mega drought but these policy churnings often create the framework for change and they are also the bread and butter for ESG so, we got to get to cooking here. And my chef today to help me is the head of global ESG research at MSCI ESG Research, Linda-Eling Lee. And she actually helped draft our comments that were sent into the SEC.

Mike Disabato:

I think they're public and you could go see them. You can go see everyone's comments and a lot of them are really interesting. But for you, so, you could listen and not have to read about it. I called Linda up and I asked her first, before we get into the details, could she give me her thoughts on the importance of this SEC consultation?

Linda-Eling Lee:

Yeah. So, first of all, I think that as we said at the outset, this was probably a bit of a surprise in terms of how quickly out of the gate the SEC have come out to seek a public commentary on just the idea of potentially a mandating disclosure. But the second surprise really is how incredibly detailed I think that the solicitation for comment are. This is not... We do a lot of consultations or at least we see a lot of them. We see a lot of these types of invitations for public commentary and I do think that the SEC one just happens to be really quite specific. The first is really around what types of climate-related disclosures should or should not be mandated for all companies regardless of sector versus being industry specific and to what extent there should be more quantitative information versus qualitative information.

Mike Disabato:

Yeah. That was one of the first big questions that the SEC asked in this consultation, what information related to climate risks should everyone be on the hook for? The first in Linda's mind and in our mind basically... Whenever I say in Linda's mind, I also mean in our mind. Is the most important and the most obvious. She wants comparable and consistent disclosures

on scope one, two, and three greenhouse gas emissions. It might not seem obvious but the actual emissions of a company are often not disclosed to the world. Scientists do have these tools to measure the total global, let's say carbon emissions but it is not really easy to say specifically that company X or company Y based on your disclosures, not on our estimates, you are responsible for X percent of these global missions and so you're doing great or you need to lower those emissions. That is unless you are a regulator and then at times that information can come out and finds after you've done an investigation.

Mike Disabato:

So, just quickly to define terms here, scope one and two emission disclosure requirements are not controversial. Everybody wants these. They are basically emissions from a company's facilities and the purchase energy which comes to companies in many forms. That's scope one, and then scope two is the purchase energy. What is a bit more, I guess, progressive, I'd say, rather than controversial is we also want the SEC to require that companies disclose on their scope three emissions. And scope three emissions are company's value chain emissions. For example, how the I-phones are disposed off are part of Apple's scope three emissions. The emissions from the fuel used to power your car are part of Exxon's scope three emissions. And based on our research, many sectors have a large part of their emissions in scope three categories. So, that's why we want them to be disclosed.

Mike Disabato:

Those scope 1, 2, 3 emission requirements, those are kind of the obvious things that everybody wants and scope three of the ones we want and a lot of other people want those as well. What is less obvious is what the second part of Linda's request is.

Linda-Eling Lee:

We really think that all companies should be disclosing where their largest facilities are. So, where they're actually operating. And the reason we think that is extremely important is that particularly for climate but also for other ESG risks, many investors are able to make a better assessment of the company's exposure to physical risks. So, that would be extreme weather. Other types of kind of physical hazards that will come from the changing climate. They're able to do that only if they know where companies are precisely located and where if some of these core operations are.

Mike Disabato:

Say you have invested in a chemical production company that has petrochemical facilities like ethane crackers or polyethylene processing plants. Those are things okay, that produce dangerous pollutions that you would want to make sure are handled safely. Well, there's a chance that those facilities are in a newly flood-prone area or in an existing hurricane corridor. Hurricanes obviously are types of storms that have increased in their ferocity due to climate change. You would want to know as an investor, as a shareholder, that the company is planning for some sort of disaster that could occur due to an extreme weather event that would shut down the facility, create a lot of problems financially and environmentally. At the

moment, one cannot easily and uniformly obtain that information as to where those facilities may be located and if the company is prepared for the region specific issues. And as the asset location leads well into the third thing that we think every sector should disclose on, supply chains.

Linda-Eling Lee:

We have seen that supply chain disruption can pose very significant material risk to companies. We've seen that most recently with, for example, the cargo ship that was stuck in the Suez canal that had ripple-on effects on supplies all around the world. We've seen that with the cyber attacks where there was a disruption to gasoline from the attack on the refinery. So, I think that with climate change, there are going to be more physical risks, more disruptions in the supply chain and today it will be very difficult for investors to evaluate how vulnerable some of their portfolio companies might be to disruptions in the supply chain because they simply have no transparency into the supply chains of companies.

Mike Disabato:

So, I'm just kind of giving you a taste here. There's a lot of technicality in these SEC disclosures, but those things are the three main data points that we want everyone, we think that the SEC should want everyone to disclose on. And the over arching reason for why we want scope 1, 2, 3 in emissions, facility locations and supply chain transparency to be disclosed by everyone in a uniform consistent and comparable manner, is that because these are the foundations with which climate change risk analysis can be conducted. If someone comes up to you and says, they care about climate change but they don't care about those three things, then they are not woke. Okay. They are not down with the analysis. Now, those are just the things that we think everyone should be reporting on. There's also sector specific metrics that we put into our consultation response that we think different sectors should report on. For example, the type of fuel used by utility to generate electricity or the sort of fossil fuel reserves an oil and gas company has on their balance sheet.

Mike Disabato:

Now you may be thinking to yourself, well, I thought a lot of companies were expressing intent to disclose this stuff but the difference here, what Linda is requesting, what we're requesting is that these metrics, these factors are reported in a quantitative matter so they can be measurable. They have to be numerical, they cannot just be what's called qualitative. They can't be the company's views on how these aspects inform their judgements of climate risk.

Linda-Eling Lee:

Quantitative in my mind would be to ask for the amount of water that has been used. Water withdrawal, or water consumption. Just report that. It's much more useful than the policy to how they use water. Which I think is also good context but I don't think as substitutes for the quantitative measure of how much water withdrawn or used or recycled.

Mike Disabato:

I'm going to use the words that Linda wrote down in the commentary because I think they also capture what she was saying there really well. That wrote, "Recitation of risks that are so broadly well-known and established as to be equally applicable to virtually all registrants add content but are of limited value to investors' understanding of the risks and opportunities facing a company due to climate change." Basically what they're worried about, what we're worried about is boilerplate language being used and passed from company to company in their climate disclosures. And it's not only a concern about usability, qualitative data doesn't do anything for calculating forward-looking risk metrics. Climate change is already around us. We are seeing it everywhere in obvious ways like mega droughts and less obvious ways like how it influences immigration. But to understand the looming risks of change those not yet theoretically priced into our world, we need to use models that produce forward-looking metrics and scenarios. And that is only possible with quantitative data.

Linda-Eling Lee:

Companies, if they write about their forward-looking risk management of climate risk, I think that's useful to some extent but certainly not as useful as if they were to actually put out a number to say, well, this is the decarbonization target that we're hoping to meet, that we're aiming to meet, that all of our strategies and policies that we might be discussing qualitatively are aiming to achieve and also here's our progress in getting there. In numerical terms, actual quantitative terms.

Mike Disabato:

There's one caveat I should note for this. We've been talking about throughout this podcast, publicly listed companies. Publicly listed companies are required to disclose a lot of information to the SEC and to investors. It comes with the territory of being publicly listed but there are a lot of private companies out there. In fact, companies have raised more money in the private markets than the public markets in each year since 2009. For example, companies raised \$3 trillion in private markets and \$1.5 trillion in public markets in 2017, according to Morgan Stanley Investment Management. I know that it's four years ago but the trend is still heading that way and allocations to private assets continue to increase. So, what Linda told the SEC was not only should public companies be mandated to do this but also private companies as well. It's not only good for investors to be able to assess climate risk for just one part of the sector. And it's also important because it is useful to ensure public companies don't offload their carbon heavy assets to the private market.

Linda-Eling Lee:

There is also kind of the incentivization piece of, if public companies start to sell some of their assets that are more fossil fuel intensive or could become carbon stranded assets into the private space and then there is no transparency on that because there is no reporting by private companies. I think that we don't really actually end up getting the kind of quality information that allows investors to allocate their capital properly.

Mike Disabato:

That is really what the SEC is after with this consultation. A way to ensure that they do not create a barrier for investors, rather, they want to create a way for investors to better peer into the infrastructure of our economic system. The market can only work well if there is enough transparency in it to allow outsiders with capital to make informed decisions. And what the SEC is saying that in 2021 disclosures on climate change have to help inform those decisions. And as Linda told me, what's interesting about the way the SEC is carrying this out, is that unlike other regions that are defining what is sustainable and what is not, the US regulators are saying, just make the right data public and the market can decide what is sustainable and what isn't.

Linda-Eling Lee:

So, let me give you an example. So, I think that when we say that we want certain industries to give disclosures on their alternative energy and green tech technology types of segments, that they should actually just give more granular reporting so that we can actually analyze them. Now, that's different from saying that they should report what percentage actually qualify under, for example, the EU green taxonomy. Because the EU green taxonomy, the goal is that there are certain categories that will be considered green and then companies then would report what percentage of their revenues actually qualify under those green taxonomy definitions. That's what I mean by prescriptive. And descriptive would be simply to say, give us all of your business segments in like very granular terms and then we can decide, as investors who may have different views about different types of technology being more green versus less green versus totally not green at all, to then make those kinds of classification.

Mike Disabato:

Having a descriptive policy rather than a prescriptive policy would at least comport with the American desire for individualism.

Mike Disabato:

Okay. So, now I have for you the proxy of the week segment, and it has to do with Toshiba, which is a massive Japanese company that basically makes everything in Japan that could be considered a strategic national product. They make computer components, energy components, industrial motors, everything that government needs to run a city basically, Toshiba can probably make. To understand what has happened this year at Toshiba though, at its proxy events, you have to know what happened last year. But that would take way too long. And so, what I'm going to do is I'm kind of going to wrap it up quickly, but if you're interested, it is a wild ride of corporate drama and voter suppression and government collusion that you should definitely look up. But basically what happened is, a major investor wanted to elect some people onto Toshiba's board, but the director didn't get enough votes to get a seat at the annual general meeting in 2020.

Mike Disabato:

That's always the time of the company elections as I usually say. The problem is people started to murmur after the AGM and say that what really happened is Toshiba didn't count all the votes and it got the government help to not do so. So, this year in March, a special shareholder meeting was convened that called for an external investigation of what went down in 2020 at the company's AGM. And the report was just provided to the public. And as Moeko Porter, a colleague of mine that lives in Tokyo and covers corporate governance in Japan told me, the report had some spice in it. What it looks like, Moeko told me, is that Toshiba's governing body and the Japanese government were really not playing fair.

Moeko Porter:

Probably the most important takeaway is that it pointed to evidence of collusion between senior Toshiba executives and officials at METI, the Ministry of Economy, Trade and Industry. With recent amendments to Japan's Foreign Exchange and Foreign Trade Act or FEFTA for short, foreign investors are required to seek government approval for investing in strategic companies such as Toshiba and also proceeding with certain actions like one of which is voting your own representatives onto the board. And the report concluded that both parties had taken actions that essentially work the pressure [inaudible 00:18:31] to withdraw its your holder proposals by referencing FEFTA. And when that didn't work, they tried to influence certain investors to ensure the shareholder proposals wouldn't pass.

Mike Disabato:

Moeko is playing it safe here. The report found that the government and the company acted illegally to suppress shareholder votes and that there was a text message between the company executives that said, "Don't worry, the government will play the main role of voter suppression."

Moeko Porter:

So, in response, Toshiba's board of directors ended up convening an emergency meeting after the report was released and ultimately announced both board and management changes. Two of the three audit committee members that had signed off on the company's initial internal investigation will not be seeking re-election. And two executives that were named in the report will also be resigning.

Mike Disabato:

The thing is, that now Toshiba's board chair has rebuffed calls to quit over the scandal. He's just flat out refusing to leave. Even as the second emergency meeting is being called. And the Japanese government is saying, what do you expect? Toshiba is a strategic company. We have this law called FEFTA, the Foreign Exchange and Foreign Trade Act that says we can impose certain regulations on foreign direct investments made by foreign investors. And this move was made by a foreign investor. And the FT has this amazing quote, because they've reported on this a bunch, that says one of Toshiba's largest shareholders said Nagayama, the board chair sounded like "a tourist" and had offered no clarity on why he thought he was fit to



lead the organization. And now people are saying this act of protectionism that's been done by the government is going to change corporate Japan forever.

Mike Disabato:

And it might mean that foreign investors, as Moeko told me over the phone, stay away from Japanese companies that could be seen as important to the government. Not only that, but according to Moeko, this report came out at the worst possible time for the Ministry of Economy Trade and Industry in Japan.

Moeko Porter:

Ironically, the investigation report came out one day before the most recent revisions to Japan's corporate governance code were made public. So, while I'm sure the government would love to be out promoting the revised corporate governance code, I imagine they probably want to maintain a low profile for a while.

Mike Disabato:

And that's it for the week. I wanted to thank Linda and Moeko for talking to me about this week's news with [inaudible 00:21:02] twist. And I wanted to thank you so much for listening. I really appreciate it. Don't forget to rate and review us wherever you get your podcasts. Hopefully that's working and don't forget to subscribe. That helps. And if you liked ESG Now don't forget to check out our other podcast. The MSEI podcast called the Perspectives Podcast. Here's what they're talking about this week.

Adam Bass:

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