RESPONSIBLE INVESTING

SEC Proposal on Climate Disclosure Will Drive Real World Innovation and Speed Up Climate Solutions

By: John Streur | June 27, 2022

Washington - Corporations throughout the world are working to transition their businesses away from the use of fossil fuels because of the increasing business risks to companies from the harm this causes people, the local environment, and global climate change. This is a massive, multidecade effort that will impact the vast majority of companies and that has material implications for every living creature on the planet-and, of course, for long-term investors. The speed and the success or failure of this transition will inform quality of life for the world's population for generations to come.

We are attempting to manage this with a voluntary market-led set of solutions. This is the cornerstone of capitalism. Markets need transparency to the problem. With adequate transparency, markets will finance the companies solving the problem, in anticipation of better returns.

Today, we lack the necessary information from companies detailing their carbon emissions, which blocks the transparency needed to produce voluntary market-led solutions. The United States Securities and Exchange Commission (SEC) has proposed a set of rules for companies to disclose their carbon emissions in order to facilitate market function and to stimulate the innovation and entrepreneurship needed to hasten the transition to a cleaner energy system.

As opposed to embracing this effort, many corporations and even some investors are pushing back, trying to water down or even block the SEC's efforts. In a nutshell, these companies are arguing that calculating and disclosing their carbon emissions is too complicated, too costly and could get them sued for their contributions to climate change once people see how much carbon they are discharging into the atmosphere.

We suggest the free-market, capitalist approach--get the information on corporate carbon emissions out to our financial markets and solve this through innovation and market-led competition. The alternative is to have the government intervene and take some degree of control of the energy system.

Transparency Is Key

This is an area that should be more math than politics. Access to better climate-related data benefits all investors, allowing them to better understand the current risks to investment portfolios and to better manage such exposures.

U.S. regulators have taken a measured approach to climate-related disclosure relative to other regulators around the world. It has focused on essential data to improve market function, facilitate voluntary market-led solutions and enhance competition and innovation through stronger market signals.

This disclosure of information doesn't mean the SEC will then be in the business of telling the market what the numbers mean. People might disagree on the interpretation of the data, so this is unlikely to lead to universal agreement. But to attempt to eliminate or control access to this critical information would be inconsistent with improving capital market function.

The Importance of Externalities

It is important to have a basic framework to understand what we mean when we discuss ESG investing. At Calvert, we use the Calvert Principles for Responsible Investing to frame our information gathering and proprietary research. These correlate to globally accepted norms for responsible business conduct. You can read them on our website here.

We also use the concept of externalities, which refers to the activities of a company that may result in impact to the environment or to people but are not well captured in the company financial statements. While companies create substantial positives, and they get paid for this through profits, they also create negatives. Problematic externalities include pollution, human rights abuse in supply chains, gender or racial discrimination and many others.

Long-term investors like Calvert seek to understand how well companies are performing on managing all aspects of their businesses, including the elimination or reduction of harmful externalities. Some companies manage this better than others, which we think is a factor in determining which companies make better long-term investments. Over time, society figures out externalities and starts charging companies for the problems they cause.

Carbon emissions are an example of a corporate externality we seek to quantify and factor into the long-term analysis of a company's future value. All else being equal, the more carbon emissions a company creates, the greater the risk to the company as society attempts to cut emissions.

The Time Is Right

We think that all the attention on climate change over the past decade has put society on the precipice of solving this existential crisis. Initiatives by market regulators worldwide to create more transparency to corporate externalities narrowly focused on climate change is a critical next step. The markets need the information in order to more accurately price this externality into stocks and bonds. Until we get this, markets will lack the required information and transparency to function optimally, and we will risk misallocating capital.

We see companies already beginning to allocate resources in efforts to decarbonize. Examples of this can be found everywhere, including the fossil fuel industry-nearly across the board. But without transparency into carbon emissions across all corporations and the resultant market valuation of that factor, we cannot see how the markets value these decarbonization strategies.

Whatever our differences are on the SEC proposal, let's be clear: This is simply about the provision of information. How one interprets the data or uses it is up to each market participant. Let's get as much transparency as possible and make our arguments in the open market, not with the regulator.

Bottom line: The SEC proposal is a pro-capitalism, pro-voluntary market-led solution and may lead to improved capital allocation, increased innovation and greater competition. We should get behind it and let the markets function.

Calvert's letter to the SEC related to "The Enhancement and Standardization of Climate-Related Disclosures for Investors" is available here.
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John Streur
President and CEO
Calvert Research and Management

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