STATE OF CALIFORNIA Dave Jones, *Insurance Commissioner*

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July 21, 2016

**VIA ELECTRONIC SUBMISSION**

Brent J. Fields
Secretary
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

**RE: Concept Release on Business and Financial Disclosure Required by Regulation S-K**

Dear Mr. Fields:

I am privileged to serve as the Insurance Commissioner of the State of California. I lead the California Department of Insurance (the "Department") and regulate the California insurance market. More than 1,300 insurance companies are licensed by the Department to sell insurance in the State of California, which has the sixth largest economy in the world.

Insurers collect US$ 259 billion a year in premiums in California, making our insurance market the largest insurance market in the United States and the sixth largest in the world. Under my leadership, the Department protects consumers, helps maintain an economically healthy insurance marketplace, and regulates the financial condition and solvency of insurers.

As a financial regulator, I support efforts to enhance disclosure of climate-related risks to assets that are held by investors, including insurance companies. Climate risk disclosures should be designed to better inform investors, consumers, markets, and regulators through improved transparency, thereby helping to reduce the potential of large, abrupt corrections in asset values which might destabilize financial markets and ultimately harm consumers, investors, and insurance policyholders. I appreciate the opportunity to provide comments to the Commission in response to the above referenced Concept Release, specifically with regard to climate-related financial risks to the insurance sector and industry (Sustainability).

The insurance industry is a vital element of the United States and global economy. Insurance products are necessary for the wellbeing and economic security of consumers, businesses, trade, commerce, and the overall economy. Insurers in the United States have over $7 trillion in assets under management. Insurers' products, pricing, and investment decisions influence business and consumer behavior across all sectors.

Since 2011, I have led the multi-state administration of an annual climate-change risk disclosure survey – the National Association of Insurance Commissioners' ("NAIC") Climate

Risk Disclosure Survey.[1] The survey asks insurers questions regarding whether they have identified climate related risks to their business operations, underwriting and reserving, and what, if any, steps they have taken to address these risks. The survey results are published on the Department's website at http://www.insurance.ca.gov/0250-insurers/0300-insurers/0100-applications/ClimateSurvey/.

More recently, and consistent with my statutory responsibility to make sure that California-licensed insurance companies identify and mitigate potential financial risks to the reserves they hold to pay future claims, I announced in January of this year the Department's Climate Risk Carbon Initiative, which currently includes:

(a) New required financial disclosures by insurers of their investments in fossil fuel (thermal coal, oil, gas, and utilities) enterprises through a survey or "data call", which is applicable to California-licensed insurers with 2015 direct written premiums equal to or greater than US$100 million nationwide ("Data Call"), and

(b) A request that California-licensed insurance companies voluntarily divest from thermal coal enterprises, applicable to all California-licensed insurers ("Thermal Coal Divestment").

I am the first insurance regulator in the United States to require that insurance companies provide detailed and public disclosure of their investments in the carbon economy and the first to call on insurance companies to divest from thermal coal. The Data Call was successfully issued in early May with a deadline of July 1, 2016 to provide the required financial disclosures of fossil fuel investments and to provide an answer as to whether the insurer will divest from thermal coal. Further information on the Climate Risk Carbon Initiative, is at http://www.insurance.ca.gov/0250-insurers/0300-insurers/0100-applications/ci.

In addition to administering the NAIC Climate Risk Disclosure Survey and the new Climate Risk Carbon Initiative, the Department also is using its routine financial examinations, its review of the new Own Risk and Solvency Assessment Act reports by insurers ("ORSA"),[2] and the new Form F filings required under the NAIC Model Holding Company Act, to obtain information about insurers' identification of and responses to climate risk.

I am pleased to share with the Commission the Department's work and experience in the area of climate risk and the insurance sector. Department comments addressing general questions within its expertise posed in this Commission Concept Release are attached.

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[1] The NAIC is the United States standard-setting and regulatory support organization governed by the chief state insurance regulators of all states.

[2] In 2011, the NAIC adopted the ORSA Model Act, under which large insurers or groups are required to file annual ORSAs with regulators. In these reports, insurance companies make their own assessment of their current and future risks through an internal risk self-assessment process which allows regulators to form an enhanced view of an insurer's ability to withstand financial stress. Included is an assessment of material risks and the capital needed to support these risks. Climate change is included in many of the risks impacting the insurance companies and groups either directly or indirectly through their assessments of other risks. For further information on ORSA, visit http://www.naic.org/cipr_topics/topic_own_risk_solvency_assessment.htm.

I congratulate the Commission for its important and meaningful work in modernizing business and financial disclosure requirements in Regulations S-K. Thank you for considering my comments.

If the Commission has any questions about this Comment Letter or the California Department of Insurance Climate Risk Carbon Initiative, including the Thermal Coal Divestment or Fossil Fuel Investment Data Call, please contact me or Mr. Libio Latimer, Director, Office of Climate Risk Initiatives, California Department of Insurance, at 45 Fremont St., San Francisco, CA 94105, USA, or [redacted]. Mr. Latimer can also be reached at [redacted].

Sincerely,

Dave Jones

**DAVE JONES**
Insurance Commissioner

## Responses to Concept Release

**Which, if any, sustainability and public policy disclosures are important to an understanding of a registrant's business and financial condition and whether there are other considerations that make these disclosures important to investment and voting decisions?**

Insurance company registrants

Insurance companies are enterprises in which others invest and are themselves investors. Disclosures by insurance companies of their investments in thermal coal, gas, oil, and utilities (fossil fuels) are important to an understanding of their business and financial condition.

The accelerating policy and private market movement away from the burning of carbon poses a potential financial risk to insurance companies investing in the carbon economy. This potential risk is that these investments will lose value over time or that they lose value quickly, thus becoming "stranded assets." In either case, carbon investments pose a potential financial risk to those who invest in them. This financial risk resulting from the movement away from the carbon economy is sometimes called "transition risk." Recently, this risk has received increased attention in national and global investment and financial circles and calls to measure and assess it in order to manage it have become prevalent.

Financial consequences of investments in fossil fuel companies have become a reality. Trillium Asset Management reports that California's two giant pension funds -- CalSTRS and CalPERS -- are estimated to have lost $5.1 billion from stock investments in oil, gas, and coal companies in 2014-2015. More than three dozen coal operations went bankrupt in just over three years and sixty-nine North American oil & gas producers have filed for bankruptcy since 2015. This past April, Peabody Energy, the world's largest private-sector coal producer, filed for bankruptcy citing "unprecedented" industry pressures and a sharp decline in the price of coal.

Insurance companies hold reserves required to pay future policy claims in investments. If the investments incur significant losses, the ability to pay insureds' claims may be at risk. A number of insurers have recognized this risk. Allianz, an international insurer and one of the world's largest financial asset managers, announced that it would decrease investments in companies using coal. Similarly, AXA Insurance Company announced last year that it will remove companies that derive more than half of their income from coal mining from its portfolio.

A recent study by Ceres and Mercer report fossil fuel holdings of the top 40 U.S. insurance groups are reported to be worth $459 billion.[3] In order to protect investors and policyholders, it is important that insurance regulators and insurance company investment committees and managers, take a careful and close look at their reserves and investments and prepare for a lower-carbon future. Because the amounts involved are significantly large, even isolated

[3] Assets or Liabilities? Fossil Fuel Investments of Leading U.S. Insurers, p. 24, Ceres (June 2016), http://goo.gl/bERjyB.

losses could impact the investing insurance companies, their policyholders, the insurance market, and the national or even global economy.

Item 303 of Regulation S-K requires that companies describe known trends, events, and uncertainties that are reasonably likely to have material impacts on their financial condition or operating performance in the MD&A section of Form 10-K or 20-F. Also, under Item 503(c) of S-K companies are required to disclose risk factors—factors that may affect a company's business, operations, industry or financial position, or its future financial performance. As the Concept Release states, a central goal of the federal securities laws is full and fair disclosure and that investors must have access to accurate information important to making investment and voting decisions in order for the financial markets to function effectively.[4]

Based on the above, insurance company registrants should, for purpose of filings with the Commission, disclose their material carbon assets, which as explained are subject to "known trends, events, and uncertainties" and are "risk factors," so that investors have access to "accurate information important to making investment and voting decisions" (and policyholders to make informed insurance policy-purchase decisions).

<u>Fossil fuel registrants</u>

Based on the above and subject to applicable materiality assessment, fossil fuel registrants and other enterprises deriving substantial income from fossil fuels should, for purpose of filings with the Commission, also disclose percentage of their revenue they generate from thermal coal, oil, and gas. Energy utility companies (private or publicly owned) should account for and disclose the energy sources used to generate their electricity, such as thermal coal, gas, oil, natural gas, purchased, etc., by percentage. If they market purchased electricity, they should account for and disclose the percentage of energy sources used by the seller to generate electricity. This data will permit insurance companies investing in them to assess their exposure to potential risks in their fossil fuel investments for purposes of their own disclosure obligations.

**Importance of sustainability and public policy matters to informed investment and voting decisions**

As the Concept Release notes, disclosure of sustainability information has not been examined in detail by the SEC since the mid-1970s. At that time, the SEC postponed calls for increased requirements for such disclosures because of, among other things, a lack of sufficient investor interest. The Concept Release, after describing this history, notes that the "role of sustainability and public policy information in investors' voting and investment decisions may be evolving as some investors are increasingly engaging on certain ESG matters."[5] I concur. Shifts in the global business context underscore the need to revisit the disclosure of sustainability issues, including climate-related risk factors, and investor interest in them.

Climate risk likely was not on the radar of investors or the Commission 40, or even 20, years

[4] SEC Concept Release, III.A.1.
[5] SEC Concept Release, IV.F.2.

ago. However, awareness of risks posed by climate change has intensified very rapidly globally in the last few years. The financial losses arising from investments in fossil fuels listed above occurred in the last five years. Many of the world's nations, and national, state and local public and private sector leaders and publics have become cognizant of the diverse, complex, and uncertain risks posed by climate change and have decided to take concerted action. On December 12, 2015, 195 nations, including the United States, agreed to the United Nation's Framework Convention on Climate Change's Paris Agreement, which has ambitions goals regarding the movement away from the burning of carbon and thus is likely to increase financial "transition risks" mentioned above.

In consideration of these recent and important developments, sustainability issues, including climate-related risk factors, have become sufficiently important and material to informed investment and voting decisions to justify modernization business and financial disclosure requirements in regulations S-K. I am fully supportive of your efforts to modernize disclosure while protecting investors and facilitating efficient functioning of the markets.

**Whether, and if so, how specific disclosures are important or useful to making investment and voting decisions and whether more, less, or different information might be needed**

Investors are interested in having access to accurate and useful sustainability information, but a 2015 study found that 82 percent of investors said they are dissatisfied with how risks and opportunities are identified and quantified in financial terms; 79 percent of the investors polled said they are dissatisfied with the comparability of sustainability reporting between companies in the same industry.[6]

Insurance companies subject to the Department's Data Call and Thermal Coal Divestment described above *need* to have access to specific disclosures of fossil fuel enterprises in which they invest in order to respond meaningfully to these regulatory initiatives.[7] Department analysis of responses, received very recently, is ongoing. Some indication has been received, however, that some disclosures with the necessary specificity to respond to the initiatives may have been difficult to obtain. Specific disclosures are not only important or useful to investing insurers making investment and voting decisions, but they are also necessary for compliance purposes. Investing insurance companies must be able to assess climate risks in investments effectively to evaluate their exposure when making investment decisions.

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[6] PwC, Sustainability Disclosures: Is Your Company Meeting Investor Expectations (July 2015), http://goo.gl/5kPlv5.

[7] For purposes of the Commissioner's Thermal Coal Divestment initiative, "thermal coal investments" are defined as direct investments in companies that generate 30% or more of their revenues from thermal coal. The request also applies to utilities that generate 30% or more of the energy they produce using thermal coal. For purposes of the Data Call initiative, "oil and gas investments" are direct investments, including publicly and privately traded securities that generate 50% or more of their revenues from oil and gas and "investments into utility companies" include investments in utilities that generate 30% or more of their electricity from thermal coal or utilities that generate 50% or more of their electricity from fossil fuels, which include thermal coal, oil and natural gas.

**Whether, and if so how, the Commission could revise its requirements to enhance the protection of investors**

While Regulation S-K already requires disclosure of material sustainability information,[8] the resulting disclosure is insufficient. As stated above, a 2015 study found that 82 percent of investors said they are dissatisfied with how risks and opportunities are identified and quantified in financial terms and 79 percent of the investors polled said they are dissatisfied with the comparability of sustainability reporting between companies in the same industry.

One reason for this may be the absence of detailed generally accepted standards that govern disclosure of material sustainability information, comparable to those of the FASB's U.S. Generally Accepted Accounting Principles (GAAP), which govern the disclosure of financial information. This may result in disclosures that are not material, comparable, complete, and reliable and are instead one-sided, "boilerplate," and irrelevant. The U.S. Supreme Court sought to avoid situations where disclosure "bury the shareholders in an avalanche of trivial information." *TSC Industries v. Northway, Inc.*, 426 U.S. at 448-49 (1976).

Detailed standards that are likely to be helpful should:

- Identify and suggest sustainability topics per industry that evidence indicates may constitute material information under Commission rules;
- Be intended to provide guidance to company management to determine what information is material and should therefore be included in registrants' periodic SEC filings;
- Be designed to provide issuers with standardized and generally accepted sustainability metrics that help ensure that disclosure is standardized, decision-useful, relevant, comparable, and complete so that investors can make better investment and voting decisions; and
- Permit continuous update on investor needs and issuers' business models.

Specifically, the standard should contain disclosure topics, performance metrics appropriate for each topic, technical protocol(s) for each metric, industry-specific activity metrics that can assist analysts to evaluate sustainability-related performance, and guidance on which, how and where in SEC filings disclosures should be included.

The Commission could revise its requirements to incorporate these detailed standards by rulemaking or it could recognize standards set by appropriate outside organizations in an interpretive release.

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[8] Item 303 of Regulation S-K requires that companies describe known "trends, events, and uncertainties" that are reasonably likely to have material impacts on their financial condition or operating performance in the MD&A section of 20-F of Form 10-K. The MD&A requirement calls for companies "to provide investors and other users with material information that is necessary to [form] an understanding of the company's financial condition and operating performance, as well as its prospects for the future." SEC, FR-72, Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations (Dec. 19, 2003), https://www.sec.gov/rules/interp/33-8350.htm. Also, under Item 503(c) of S-K companies are required to disclose "risk factors"—factors that may affect a company's business, operating history, and financial position. 17 C.F.R. 229.503(c).

One such outside organization is the Sustainability Accounting Standards Board (SASB), an independent 501(c)(3) nonprofit organization that issues sustainability accounting standards for the disclosure of material sustainability information in SEC filings. SASB has issued Standards for 79 industries, including Financial Sector – Insurance, consistent with the definition of "materiality" under the federal securities laws.[9]

The Department has reviewed SASB's Sustainability Accounting Standard on Insurance and similar standards on fossil fuel industries and has found them to be a step in the right direction. They are largely consistent with the principles identified above. SASB's materials and Sustainability Accounting Standards on Insurance and fossil fuel industries show a serious and robust approach to its work under the leadership of prominent figures in financial disclosure.

SASB's Sustainability Accounting Standards on Insurance identifies Integration of ESG Risk Factors in Investment Management as one material sustainability topic within the insurance industry and calls for registrants to discuss how they assess and identify the risks to its investment portfolio(s) presented by climate change. I concur. In addition, as I stated above, insurance company registrants should, for purpose of filings with the Commission, disclose their material carbon assets so that investors have access to accurate information important to making investment and voting decisions (and policyholders to make informed insurance policy-purchase decisions). SASB's Sustainability Accounting Standards guide on Insurance does not explicitly call for this disclosure.

<u>Mechanism to recognize standards set by outside organizations</u>

Recognition by the Commission of standards set by outside organizations has precedent. For example, in its adoption of a final rule under Section 404 of the Sarbanes-Oxley Act, the Commission referred to the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Framework as an acceptable approach for management's evaluation of internal control. The SEC Release stated:

> After consideration of the comments, we have modified the final requirements to specify that management must base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. The COSO Framework satisfies our criteria and may be used as an evaluation framework for purposes of management's annual internal control evaluation and disclosure requirements.[10]

Other outside disclosure organizations that issue sustainability guidelines might exist and since developments in disclosure are ongoing, disclosure standards may change with time. SASB Standards reviewed show that significant work has already been done with ample outside feedback.

[9] SASB Sustainability Accounting Standards are available at http://www.sasb.org/standards/download/.
[10] SEC Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports (August 2003), https://www.sec.gov/rules/final/33-8238.htm.