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ENVIRONMENTAL, SOCIAL AND GOVERNANCE MATTERS: THE RAPIDLY EVOLVING ESG REPORTING LANDSCAPE - PART 1

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INTRODUCTION

Environmental, Social, and Governance (ESG) issues have been a mainstream business concern since 2015, when the United Nations' member nations adopted the UN Sustainable Development Goals and countries around the world adopted the Paris Climate Agreement. The financial community has seen a groundswell of investor interest in ESG factors as ESG information is increasingly viewed as significant to investment decisions. At the same time, some investors complain that corporate disclosures in filings with the Securities and Exchange Commission (SEC or Commission) frequently are confined to boilerplate, and are of limited value to investors who seek to evaluate companies' ESG risks. Investors have called for the SEC to enhance its disclosure requirements and for the US Congress to enact new laws to mandate more ESG disclosures. Some companies and other market participants have expressed concern that enhanced disclosure requirements will be costly for companies without yielding additional material information for investors. Debate among market participants circles around such issues as whether prescriptive line-item disclosures would be superior to the current principles-

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based disclosure framework, whether and how the concepts of materiality and the reasonable investor are changing, and how companies might balance liability concerns against their stakeholders' desire for more robust ESG information.

ESG disclosure is particularly challenging because it is both broad in scope, touching virtually all companies, and also specific in the details, with wide variances across industries and from company to company within an industry. Furthermore, environmental and social concerns that might formerly have been viewed as fringe issues, untethered from financial returns, increasingly are recognized as financially material, mainstream business concerns. Yet it appears that the risks and opportunities associated with ESG factors have not yet been fully integrated into some companies' critical functions, including the financial reporting process.

In the absence of definitive rules from the SEC, a host of voluntary reporting standards has emerged. The reporting landscape is a patchwork of disclosure regimes that has left some issuers with questionnaire fatigue and others simply confused as to what guidance to follow and how to reconcile the different standards. These reporting frameworks reflect invest-

tors' desire for more information as to companies' ESG performance and risks. Yet the lack of standardization around the frameworks leaves companies with the challenge of determining which regimes to follow and how to reconcile the different guidance. Investors, in turn, complain that current disclosures are not decision-useful and are neither consistent nor comparable from company to company. This mismatch between investors' informational needs and companies' current disclosures has spawned a proliferation of private sector questionnaires, surveys, ratings systems, and indexes designed to help investors to better evaluate the ESG risks and opportunities facing the companies in which they are invested.

This Report offers an overview of the SEC reporting requirements as well as the principal voluntary reporting regimes. It explores the divide between the types of information investors desire—such as decision-useful, comparable ESG information across companies within industries—and the types of information that companies most commonly report. Finally, it offers some thoughts as to potential paths forward for companies navigating this landscape.

ESG: AN OVERVIEW

ESG factors cover a broad swath and touch on all companies, and yet they do not touch on any two companies in precisely the same manner. *Environmental* factors include the direct and indirect impacts and regulation of climate change, greenhouse gas (GHG) emissions, resource availability and depletion (including critical resources such as water and raw materials), waste and pollution, deforestation, and desertification. *Social* factors include employee and supply-chain working conditions (including compliance with laws regarding slavery, child labor, health, and safety), local communities (including those of indigenous people), diversity, and economic stability. *Governance* factors include executive pay, anti-bribery and corruption, political engagement, board diversity and structure, internal controls,

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corporate ethics, and shareholder rights. Governance also broadly encompasses the manner in which companies address environmental and social risks and the processes companies implement to integrate those risks into company strategy.

ESG issues are both difficult to regulate and challenging for issuers and investors, because they cover a broad range of risks and opportunities and at the same time require industry-focused and company-specific information. Climate change, specifically, is a current threat that poses risks that are of significant concern. Yet the potential impacts on companies' financial statements are difficult to quantify due to uncertainty concerning specific projected impacts. The Task Force on Climate-Related Financial Disclosures (TCFD) has observed that "the large-scale and complex nature of climate change makes it uniquely challenging, especially in the context of economic decision-making."¹

A roundtable discussion sponsored by the Sustainability Accounting Standards Board (SASB) in July 2018 pointed to the diversity of companies and their risks as well as the diversity of investors and their interests as a challenge for those seeking to build ESG reporting standards: "Corporate professionals, investors and other market participants cited a laundry list of obstacles holding up progress toward unlocking the full potential of ESG data for both corporate and investor decision-makers. At the root of many of these issues was the market's attempt to establish a one-size-fits-all solution to measuring ESG performance . . . no two companies—and no two investors - are exactly alike."²

ESG ISSUES ARE TOP OF MIND FOR MANY COMPANIES

The sense of urgency around climate risks is intensifying, and ESG issues have become a critical strategic and operational concern of companies across industries. McKinsey reports that its May 2019 Global Sustainability Summit was at capacity: "The crowd was the largest and most senior we've

seen, which is no surprise given sustainability is now on the top of every leader's agenda."³ The issue now transcends concerns around investor relationships and stock market performance and focuses on the major shifts in industries that have been affected by the transition to a lower-carbon economy. According to McKinsey:

*We are facing two tipping points: one is economic, and one is environmental. The economic tipping point consists of industry-specific transitions that are driving decarbonization of entire sectors, where players in these industries are taking advantage of the quick pace of innovation to turn sustainability into a competitive advantage. And the environmental tipping point, of course, will determine whether our Earth remains stable—or not.*⁴

The World Economic Forum echoes this sense of urgency in its 2019 Global Risk Report, which finds that "environmental risks continue to dominate the results of our annual Global Risks Perception Survey (GRPS). This year, they accounted for three of the top five risks by likelihood and four by impact. Extreme weather was the risk of greatest concern."⁵ The report describes 2018 as a year of fires, storms, and floods. In addition, the report cites the acceleration of biodiversity loss as a significant concern, with compounding effects on ecosystems, climate change, and food security: "Of all risks, it is in relation to the environment that the world is most clearly sleepwalking into catastrophe."⁶

The risks are not lost on the business community. The US Chamber of Commerce Foundation recently conducted a series of roundtables across the United States with a view to collecting information as to how market participants—public company board members, sustainability officers, corporate executives, institutional investors, and others—view the ESG landscape.⁷ The Chamber reports, "Today, more than 80% of companies in the S&P 500 publish an annual sustainability report, a roughly four-fold increase over the past decade. The broad consensus is that heightened attention to ESG topics

offers value to the business community, investors, and the public, and is not expected to recede anytime soon.”⁸

GROWING INVESTOR INTEREST IN ESG

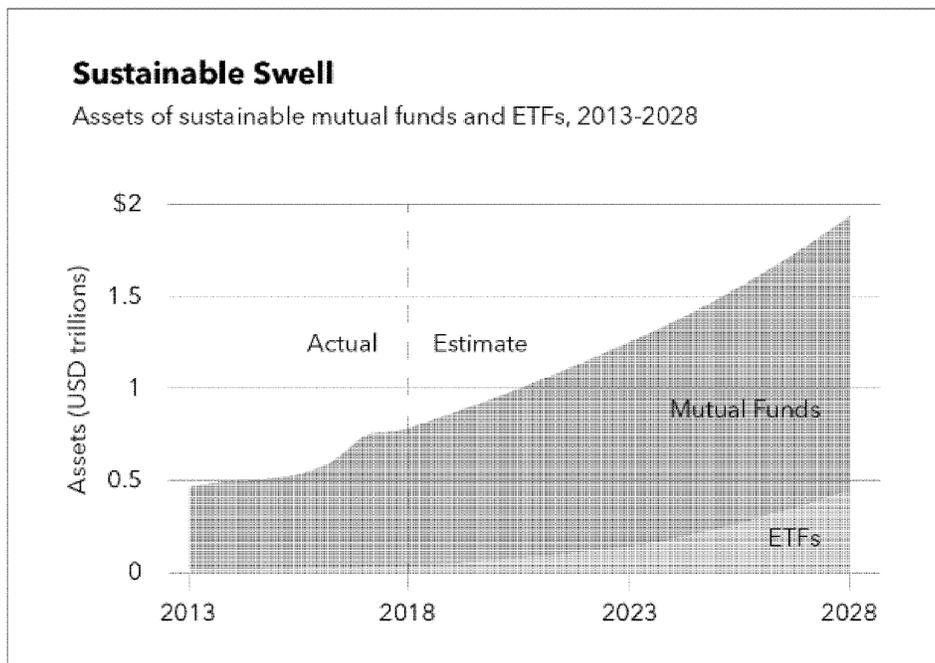
The investor community is keenly focused on ESG issues. The broad adoption of the UN Principles for Responsible Investment (PRI) among investment professionals illustrates the point. The UN adopted the PRI in 2006, establishing a set of investment principles by which the signatories incorporate ESG considerations in their investment processes.⁹ As of August 2019, firms that have subscribed to the PRI control nearly \$90 trillion in assets under

management. According to the Global Sustainable Investment Alliance, “Globally, sustainable investing assets in the five major markets stood at \$30.7 trillion at the start of 2018, a 34 percent increase in two years.”¹⁰ In the United States, the Alliance reports, “total US-domiciled assets under management using sustainable strategies grew from \$8.7 trillion at the start of 2016 to \$12.0 trillion at the start of 2018, an increase of 38 percent.”¹¹

BlackRock produced the following infographic as part of a recent study on sustainable investing. The study found steady growth in investments in sustainable ETFs and mutual funds over the past five years and anticipated further growth over the coming decade.¹²

The growth of sustainable investing

Assets in dedicated sustainable investing strategies have grown at a rapid pace in recent years, and this trend is showing no signs of slowing.



The US Chamber of Commerce report concludes that “both publicly held and private companies in the United States face increased pressure not only from investors but also from customers, employees, and others to publish more (ESG) information. For a variety of reasons, this pressure is likely to intensify.”¹³ The participants in the SASB roundtable agreed, citing the importance of ESG factors in helping shareholders understand companies’ risk profiles, particularly when ESG risks relate to intangible assets.¹⁴

Another report, issued in September 2018 by Bank of America Merrill Lynch, finds ESG issues to be increasingly important to investors. Noting the expansion of the bank’s ESG work over the prior several years, the report provides that “ESG is too critical to ignore. Asset potential is substantial: we conservatively estimate that flows into ESG-type funds over the next few decades could be roughly equivalent to the size of the S&P 500 today.”¹⁵ This report draws a strong correlation between good environmental scores and good corporate performance. The report cites a study of S&P 500 companies between 2005 and 2017 that found that those companies with high environmental scores outperformed companies that rated lower on environmental scores by as much as 3% per year.¹⁶ The report concludes that “ESG is a better signal of earnings risk than any other metric we have found.”¹⁷

A 2018 survey of institutional investors by Bloomberg and the Morgan Stanley Institute for Sustainable Investing reaches a similar conclusion.¹⁸ The survey includes written questions and responses from 300 US asset managers with at least \$50 million in assets under management, along with verbal interviews with some participants. The report concludes that “sustainable investing has gone mainstream in the United States . . . Asset managers surveyed foresee a rosy outlook for both client demand and competitive returns, and will continue to build their sustainable investing capabilities and product portfolios in the coming years.”¹⁹ The participants shared the view that sustainable invest-

ing is “here to stay,” with 89% indicating that it is a permanent feature of the investment landscape and 63% projecting growth in sustainable investments among asset managers over the next five years.²⁰ Eighty-two percent of respondents saw strong ESG performance as a key to improved profitability and investment returns.²¹ A similar 2018 survey of 260 institutional investors by EY reveals “notable consensus that ESG information is critical to investor decision-making.”²² This survey also finds a positive trajectory of institutional investors’ interest in ESG information: “ESG information plays an increasingly important role in the investment decision-making process,” and nearly all respondents (96%) said that such information had played a pivotal role.²³ According to EY, the response to the survey represents a “dramatic increase from the 2017 survey.”

A State Street Global Advisors survey of 475 global institutional investors in the United States, Europe, and Asia, including some of the largest pension plans, endowments, and foundations, draws similar conclusions.²⁴ Eighty percent of those surveyed said they incorporate ESG in their investment strategies, and 68% indicated that integration of ESG has significantly improved returns.²⁵ Furthermore, 69% of respondents indicated that pursuing an ESG strategy has helped them manage volatility.²⁶ The survey points to not only risk mitigation as a reason for investors’ focus on ESG factors, but also opportunities for value creation and the correlation between good ESG performance and good financial returns. According to the survey, “many investors believe that effective ESG management improves company performance by helping to identify reputational, operational and financial risks and create commercial opportunities.” State Street’s Lori Heinel explains that “increasingly, there is a broader appreciation of the idea that good governance translates into better management of areas such as carbon footprint and workforce engagement. This creates better quality companies that provide better performance over the long-term.”²⁷ The survey notes the

rapid rise of ESG investments in the United States and attributes that rise in part to US Department of Labor guidance that in 2015 acknowledged that ERISA-governed pension plans may properly take ESG considerations into account.²⁸

The TCFD’s 2019 status report finds that “there is a growing demand for decision-useful, climate-related financial information by investors. There likely are many factors driving investor demand, ranging from European regulations requiring certain investors to disclose climate-related information to weather-driven events resulting in significant financial impacts and leading investors to seek better information on their exposure to climate-related risks. As evidence of this demand, more than 340 investors with nearly \$34 trillion in assets under management have committed to engage the world’s largest corporate greenhouse gas emitters to strengthen their climate-related disclosures by implementing the TCFD recommendations as part of Climate Action 100+.”²⁹

A recent Goldman Sachs equity report emphasizes the investment value of ESG integration and the still untapped potential in applying ESG factors in the investment process: “We believe the potential benefits of ESG are underutilized by asset managers. In our view, ESG integration offers a differentiated and alpha-additive complement to fundamental analysis with the added benefit of helping to attract and retain a growing pool of assets. As corporate disclosures and dialog continues to improve, investors will be better able to assess ESG’s influence on a company and stock performance, helping to further deliver alpha and refine engagement.”³⁰

CURRENT STATE OF DISCLOSURES IN FINANCIAL REPORTS: PERSPECTIVES FROM THE TRENCHES

The SASB and the Harvard Law School hosted a roundtable in June 2017 that examined the legal issues and practices around US public companies’

sustainability disclosures.³¹ This group included 29 leading scholars and practitioners from law schools, businesses, the nonprofit sector, law, and accounting. The group touched on a number of issues at the heart of US public companies’ disclosures, including:

MATERIALITY

Naturally, the starting point for any discussion of the information that must be disclosed under the US securities laws is materiality. The black letter definition of “materiality” as set forth by the US Supreme Court in *TSC Industries v. Northway* provides the framework: “There must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information available.”³² Put differently, there must be “a substantial likelihood that a reasonable shareholder would consider (the omitted information) important in deciding how to vote.”

The discussion of ESG issues raises the question of who the “reasonable investor” or “reasonable shareholder” is. Some years ago, activist groups raised their hands to request enhanced disclosures of environmental and social information—but those groups were not generally considered representative of the reasonable investor. If the information requested was not tied to the creation of financial value for shareholders, then it was not, as a rule, thought to be material. Times have changed, and ESG information is now important to mainstream investors. At the Harvard legal roundtable, “one participant noted that in a 2015 survey of 1,325 CFA Institute members (portfolio managers and analysts), 73 percent said they use environmental, social and governance data in their investment analysis and decisions . . . ‘If 73 percent of sophisticated investors are using the information, we can almost stop right there when asking if this is material information.’”³³ It is commonly accepted that in many circumstances, ESG information is material. Nonetheless, not all ESG information is material, nor should the range and scope of ESG information that some investors

are requesting from companies necessarily be considered material. The determination as to what information is material to any particular company requires an analysis of the information and its specific relevance to that company and its prospects.

THE QUARTERLY EARNINGS CALL

One of the Harvard legal roundtable participants argued that ESG information is perhaps not as important as some maintain. He noted that financial analysts appeared not to be asking about sustainability disclosures on quarterly earnings calls. That commenter postulated that sustainability information is perhaps not altogether significant to investors, or at least to the analysts covering the earnings calls.³⁴ If true, then this would seem to point to a misalignment between the financial analysts covering the quarterly earnings calls and the broader investor community calling for greater disclosure of ESG factors, as indicated in the CFA survey.

One theory advanced during the Harvard legal roundtable is that, to the extent analysts are not focused on sustainability concerns, it is because these issues are perceived to have a longer time horizon than the quarterly financial information that is the focus of the calls.³⁵ Sustainability issues are believed to pose risks that are understood to be significant but that in some cases might not be realized for some time, and the impacts are perhaps difficult to anticipate. As such, they don't necessarily garner the attention of analysts on the quarterly calls. Furthermore, some of the roundtable participants questioned whether risks with a long time horizon of perhaps five or ten years should be considered material or, at least from a civil liability perspective, whether their omission would be actionable.³⁶ All of that said, the idea that climate risks involve long time horizons is not universally accepted. Indeed, the TCFD 2019 Status Report cautioned against assuming that all climate-related risks are temporally remote: "Many companies incorrectly view the implications of climate change to be relevant only in the long term and, therefore, not necessarily rele-

vant to decisions made today. Those views, however, have begun to change."³⁷ The Bank of America Merrill Lynch report drew a similar conclusion, reporting that "whereas last year, ESG was more popular with long-term investors, this year, use broadened out to clients with shorter time horizons."³⁸

A chicken and egg issue may also be at play. If analysts are reticent about ESG issues on quarterly earnings calls, does that cause those preparing the financial reports to pay less attention to sustainability issues than many investors might like? As one Harvard legal roundtable participant postulated, "Investors may be looking for sustainability information . . . but the people in companies who are preparing information for disclosure are not hearing it."³⁹ Others suggested that the chicken and egg issue goes further. Analysts might not be asking probing questions about sustainability issues because they might not yet have a sense for how those issues are likely to impact the companies' financial results. Until there is more widespread disclosure of companies' sustainability risks within an industry, analysts might not have the information they need to ask the right questions. According to the roundtable, "Disclosure of sustainability information may not be useful to investors and analysts until they better understand it, but they cannot develop their understanding until the information is being widely disclosed."⁴⁰

Furthermore, the Goldman Sachs equity report suggests that the tides are shifting and that ESG issues are making their way onto quarterly earnings calls: "A common refrain from investors has been that companies rarely if ever talk about ESG topics on earnings calls. The evidence below shows that this is changing in significant ways."⁴¹ A GS Data Works review of transcripts of quarterly earnings calls for the S&P 500 from 2000 through 2017 and found a 75% increase in the number of companies discussing environmental and social issues on earnings calls. By the end of 2017, 230 companies (nearly half of the S&P 500) discussed environmental and social issues on their quarterly earnings calls.⁴²

IDENTIFYING THE ESG INFORMATION THAT IS MATERIAL TO THE PARTICULAR COMPANY

Issuers need to evaluate which ESG data are most significant for their companies. As noted below, companies complain that they are suffering from questionnaire fatigue, and investors say they are frustrated by the proliferation of information that is of little relevance. A key to bridging this divide is for companies to evaluate and discuss the ESG information that is most important to their performance now and in the future. One SASB roundtable participant expressed a desire for “a methodology that pulls out the relevant pieces and uses those as guideposts.”⁴³ The SASB notes that “a given sustainability factor will not be financially material for all companies, and when it is material, it will manifest in unique ways from one industry to the next, thus requiring performance metrics tailored to the specific impact.”⁴⁴ Due to the bespoke nature of sustainability risks, the SASB emphasizes that the materiality determination must be made by each company based on its own facts and circumstances.

The SASB roundtable highlights some corporate squeamishness over use of the word “materiality” (termed “the M word” in the roundtable report). The concern might stem in part from definitions of materiality that have emerged in the sustainability reporting world that differ from the definition in the financial world. Most companies issue sustainability reports separate and apart from their financial reports. Many include in those reports a “materiality matrix” that presents sustainability factors of significance to a variety of the companies’ stakeholders. The Global Reporting Initiative (GRI) developed one method for determining what information is material: the “GRI materiality process guides companies in how to identify their major sustainability impacts, and then enter into a dialogue with key stakeholders—which they define themselves—to answer the question ‘What are the material Aspects, and to whom?’ Each company designs its unique process as a reflection of its needs and in the context

of its business model and sustainability strategy.”⁴⁵ This definition of materiality differs from that applied under the US securities laws, and this difference can lead to confusion and concern over what information is financially material and therefore subject to disclosure in financial reports versus information considered “material” under the GRI definition. Indeed, the GRI notes that the definition of materiality in the context of sustainability reporting is broader than that for financial reporting and therefore could well capture a broader universe of information than that which is required to be disclosed in SEC filings. “The materiality focus of sustainability reports is broader than the traditional measures of financial materiality,” the GRI reports “In financial reporting, materiality is commonly thought of as a threshold for influencing the economic decisions of those using an organization’s financial statements—investors in particular. Materiality in sustainability reporting is not limited to those sustainability topics that have a significant financial impact.”⁴⁶ The potential for confusion between financial materiality and the broader materiality in the context of sustainability reports has led to concern among companies. As one SASB roundtable participant notes, with regard to her company’s sustainability report, “We’ve been told by our legal team to reserve that term (materiality) for financial filings.”⁴⁷

Inherent in the discussion of materiality is the idea that the information that is important to investors evolves over time. We are in a period of change. Investors’ informational needs are changing, and the concept of what information is material and therefore subject to the disclosure requirements of the US securities laws should be expected to evolve as a result.⁴⁸ According to the Harvard legal roundtable, “This ability of the disclosure regime to evolve alongside the reasonable investor is crucial in today’s market, where broad macroeconomic trends such as population growth, globalization, and technological innovation have contributed to environmental and social impacts such as climate change, resource scarcity, and rising economic inequality.”⁴⁹

WHO “OWNS” SUSTAINABILITY DISCLOSURES? SILOS WITHIN COMPANIES

Some of the Harvard legal roundtable participants suggested that while companies commit significant resources to sustainability efforts, those resources reside in silos, separate from the groups that control the financial reporting function, such as finance, accounting, legal, risk management, and investor relations. Such silos can potentially cause companies to fail to develop a thorough understanding of how sustainability risks might impact their financial results—which can lead to a failure to explain those risks in their financial reports. Alan Beller, former Director of the SEC’s Division of Corporation Finance, indicated during a SASB symposium that poor communication across functions within some companies could be impairing the disclosure process. “I don’t think companies are doing as good a job as they should in vetting and coordinating across their organizations the information they’re putting in those sustainability questionnaires,” he said. “All too often, when I’ve asked disclosure lawyers at various companies for their views on sustainability matters, the response has been something like ‘Oh, that’s not material’ . . . And if you then ask them, ‘Well, what’s in your sustainability questionnaires?’ they look at you with a blank stare and say, ‘We have no idea.’”⁵⁰

Sustainability issues have seen a rapid emergence as a key concern over the past several years. Some companies have indicated that it will take time to integrate ESG issues into their core decision-making processes. According to the Harvard legal roundtable, “Adapting to a new reality, in which sustainability is wholly integrated into a firm’s strategy, operations, and reporting processes—not to mention its organizational structure—necessarily involves a certain amount of time, effort and expense.”⁵¹ A participant in the SASB roundtable reinforced this idea. The process of verifying ESG information “involves many subject matter experts across her company who ‘have full-time day jobs.’”⁵² Furthermore,

traditional positioning of sustainability or corporate social responsibility functions in many companies reinforces the silos. Sustainability in many companies historically has resided within the public relations group, which has focused on the concerns of stakeholders other than shareholders. That legacy positioning might still contribute to the segregation of sustainability from the core business and financial operations of some companies.

One potential cause for ships’ passing in the night over ESG within some companies is the lack of a common language to discuss ESG issues. The SASB roundtable emphasized the importance of fostering a productive discussion of ESG issues both within companies and between companies and investors. And in order for those discussions to be productive, the parties must speak in a common language. The roundtable participants “agreed that collaboration is key, so an important next step is overcoming language barriers within companies (e.g., between sustainability and finance), between companies and their investors (e.g., earnings calls, investor relations, etc.), and in markets more broadly.”⁵³ Others cautioned, however, that “speaking the same language is particularly challenging when sustainability is the domain of a separate department that isn’t today embedded in core business functions such as finance, operations, or risk management . . . Establishing strong cross-departmental relationships can foster mutual respect and help bridge the communication gap.”⁵⁴ Another participant agreed that embedding sustainability in the core functions of the company is critically important if companies are to move beyond “checking the box” on sustainability issues and stressed the importance of senior-level support to establish a corporate commitment to including sustainability factors as a core concern.

PROLIFERATION OF PRIVATE SECTOR QUESTIONNAIRES AND VOLUNTARY DISCLOSURE STANDARDS

The apparent disconnect between investor demand for sustainability information and companies’

disclosures in their financial reports has given rise to a proliferation of private sector questionnaires and voluntary reporting frameworks. The US Chamber of Commerce report indicates that some companies have been asked to complete more than 250 surveys related to their ESG performance, saying,⁵⁵ “This has left many issuers ‘dazed and confused’ and has required them to dedicate entire teams of employees to filling out surveys or responding to third parties about ESG matters.”⁵⁶

One Harvard legal roundtable participant noted that companies might be spending millions of dollars completing extensive questionnaires. It is not entirely clear, however, that the information produced is useful to investors. According to the roundtable, “Because many of these initiatives appeal to a broad group of stakeholders (including NGOs, employees, customers, communities, and others), they lack the focus of mandatory public filings, which are guided by an investor-centric conception of materiality. As a result, such reports cast a very wide net, capturing dozens or, in many cases, hundreds of data points covering a wide swath of subjects, many of which may not be relevant to a company’s business or to its investors.”⁵⁷ The legal roundtable participants expressed concern that some companies are spending significant sums to provide sustainability information to stakeholders, but without running that information through the rigor of assessing which part of the information is material to the company’s business. As such, that information’s value to investors may be diminished. In discussing how companies might sift through the sustainability data to determine what information to disclose to investors in their financial reports, one person noted the importance of tying the information to economic value. For risks that involve medium-to-long-term impacts and data whose impact is not immediately apparent, it is all the more important for companies to understand and explain how these factors impact their economic value.

The US Chamber of Commerce report reveals companies’ concern over the proliferation of

standard-setting bodies, which have developed different recommendations as to the ESG disclosures companies should make. These recommendations have been criticized in some instances for creating more uncertainty than clarity. According to the report, “The vast differences in approaches these standard setters take has created a great deal of uncertainty for companies regarding what they are expected to disclose.”⁵⁸ Further, the report finds that the emergence of for-profit ratings services that summarize and compare companies’ ESG performance is not altogether helpful. These services, the report concludes, “do not employ any type of standardized metrics or methodologies, provide varying levels of transparency with respect to their rating methodologies, and often arrive at very different opinions regarding a company’s ESG performance.”⁵⁹ The State Street Global Advisors survey similarly finds “a range of challenges that can inhibit investors’ capacity to embrace ESG investing more fully. Issues around metrics and a lack of standardized performance measures can lead to confusing and contradictory results and prove particularly concerning.”⁶⁰ It bears noting that sustainability ratings services are not universally criticized. These ratings are perceived by some to offer a valuable service to investors. “For investors, asset managers and consultants, sustainability/ ESG scores (provided by sustainability rating services) allow for a quick assessment of how well a company is run. Such scores can also forecast potential risks or untapped opportunity.”⁶¹

The participants in the SASB roundtable concluded that confusion around the different standards can cause companies and investors to talk past each other. “Coupled with the rapid pace of change, this profusion of initiatives—the ‘alphabet soup,’ as several participants called it—has created confusion in the marketplace that has neither benefited from nor facilitated a well-established, commonly accepted set of best practices,” the SASB reports. “The result, attendees noted, has been a communication gap between companies and their investors. As one participant commented, ‘They are talking past each other.’”⁶²

The 2018 survey of institutional investors by Bloomberg and the Morgan Stanley Institute for Sustainable Investing draws the same conclusion: “There remains significant confusion around definitions of sustainable investing and approaches to measuring social and environmental impact. While existing efforts such as the Sustainable Accounting Standards Board (SASB) guidance continue to gain traction, no single set of metrics has fully addressed the need for comparable, high-quality ESG data. Industry engagement in efforts to create a common language of sustainability and impact remains paramount to overcoming this challenge.”⁶³

This is not to say that the voluntary sustainability reporting frameworks are not helpful to some. Indeed, the Conference Board has emphasized that “voluntary reporting frameworks, such as the (Global Reporting Initiative) Standards, play an important role in helping companies navigate non-financial disclosure.”⁶⁴ However, “check the box” exercises are thought to be less useful than disclosures that focus on the factors that are material to the particular company: “Nonfinancial disclosure alone does not necessarily translate into better sustainability performance as companies tick the boxes without tipping the scales . . . Existing reporting requirements are more effective when they include due diligence mechanisms to achieve not only greater disclosure but also performance improvements.”⁶⁵

IMPERFECT FIT BETWEEN THE INFORMATION THAT INVESTORS WANT AND THE INFORMATION THEY RECEIVE

A number of market participants have noted the disconnect between the data that companies are providing and the information that many investors would find useful. The World Business Council for Sustainable Development (WBCSD) conducted a study that included a series of investor roundtables and interviews to gain a better understanding of the information that investors want in order to properly incorporate companies’ sustainability performance

in their capital allocation decisions.⁶⁶ The WBCSD reports:

*There is a clear appetite from investors for information outside of the financial statements. The investors interviewed said it gives important context to the financial information and insight into the long-term viability of the company. But investors can be skeptical about its relevance and reliability. Over a series of interviews and roundtables, investors explained the challenges they face in using (non-financial information)—with many of these arising from the numerous reporting frameworks and initiatives in this area, the sheer volume of information reported and the perceived lack of high-quality, consistent and comparable information.*⁶⁷

The study participants indicated the factors that would enhance their confidence in and ability to make use of the information provided. Investors expressed their wish that companies more clearly identify and discuss the risks specifically impacting them. Further, they expressed a desire to discern whether companies have good governance and effective internal controls, not only over financial reporting but also over non-financial factors such as ESG risks.⁶⁸ According to the WBCSD, “Investors want companies to show how (non-financial information) is integrated in their strategic decision-making and are looking for material information to be underpinned by controls and processes on a par with those used for financial information.”⁶⁹

The study participants also articulated the difficulty of incorporating non-financial information in their valuation models. The investors interviewed emphasized the importance of providing ESG metrics for comparability across companies and within companies across time. However, the metrics alone are of limited use without narrative discussions that explain how the data are relevant to companies’ performance and outlook.⁷⁰

The SASB roundtable participants expressed sim-

ilar frustration, noting investors' "increasing appetite" for high-quality ESG information. While companies are providing huge amounts of information at significant expense, at the end of the day, the roundtable participants noted, "investors are overwhelmed by the amount of information" and left searching for needles in a haystack.⁷¹ The corporate participants in the roundtable discussion expressed their own frustration with the proliferation of questionnaires, with one participant bemoaning the litany of questionnaires and surveys that "just doesn't end."⁷² Recognizing the state of mutual dissatisfaction, participants arrived at the conclusion that there is a need for an ongoing dialogue between the investor and corporate communities to come to a better solution. Ultimately, a central theme that emerged is that "as relatively new practices, ESG reporting and integration are—and should be—works in progress."⁷³

The SASB issued a report in 2017 that provides its assessment of the effectiveness of sustainability disclosures in SEC filings. The report bases its conclusions on the SASB's review and analysis of sustainability disclosures in hundreds of SEC filings across industries. Consistent with the other discussions noted above, the SASB report finds that there is still significant work to be done toward making disclosures in SEC reports meaningful and useful to investors. In his foreword, Alan Beller declares, "On the one hand, it is heartening that companies increasingly recognize the risks and opportunities involved in managing material sustainability factors and the requirements . . . to disclose them in communications with investors. On the other, their communication to investors on these issues remains largely designed to address liability concerns, and are thus ineffective in providing meaningful and comparable information. So much work remains to be done."⁷⁴ The report specifically finds that most sustainability disclosures rarely include sustainability performance metrics and typically consist of boilerplate language "which is largely useless to investors."⁷⁵

The Bank of America Merrill Lynch report finds a

similar disconnect between US companies' and investors' views of the importance of ESG factors to the investment process. The report results indicate that more than 25% of institutional investors reported using ESG factors in their investment process. Notwithstanding that significant investor interest in ESG, issuers estimated that less than 5% of their outstanding shares are managed by ESG-focused investors.⁷⁶

CURRENT REPORTING FRAMEWORK IN THE UNITED STATES

SEC REPORTING REQUIREMENTS AND GUIDANCE

Regulation S-K⁷⁷ underpins the reporting obligations of the Securities Act and the Exchange Act and provides the basis for required disclosure of material ESG factors in registration statements and periodic reports.⁷⁸ Specifically, disclosure of material ESG factors might be required under Item 101 of Regulation S-K—Description of Business,⁷⁹ Item 103—Legal Proceedings,⁸⁰ Item 105—Risk Factors,⁸¹ and Item 303—Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).⁸² Further, Securities Act Rule 408 and Exchange Act Rule 12b-20 require disclosure of such material information as is necessary to make the required disclosures not misleading, in light of the circumstances in which they are made.⁸³ The Commission issued guidance regarding disclosures related to climate change in 2010 that continues to inform registrants' climate change disclosures under the US securities laws (2010 Interpretive Release).⁸⁴ While the 2010 Interpretive Release contains guidance and examples specifically focused on climate change, its description of disclosure taxonomy applies equally to other ESG disclosures.

Item 101 of Regulation S-K: Description of Business. Item 101(c)(1)(xii) requires "disclosure of material effects that compliance with Federal, State

and local (environmental laws and regulations) may have upon the capital expenditures, earnings and competitive position of the registrant.” Item 101 also requires disclosure of material anticipated capital expenditures for environmental controls for the current and following fiscal year and such longer period as the registrant deems material.⁸⁵ The laws or regulations that could materially impact a registrant include those enacted by the federal government, the states, local municipalities, or foreign authorities. In the 2010 Interpretive Release, the Commission pointed to the then pending cap-and-trade bills before Congress and then pending EPA rules to regulate GHG emissions, as well as the Kyoto Protocol. The Commission noted that, while the United States had not ratified the Kyoto Protocol, it nonetheless could materially impact US registrants with operations outside the United States that are subject to its standards.

Item 103 of Regulation S-K: Legal Proceedings. Item 103 requires the registrant to describe any material pending or contemplated legal proceedings to which the registrant or any of its subsidiaries is a party or to which their property is subject. The requirement excludes ordinary, routine litigation that is incidental to the registrant’s or its subsidiaries’ business. However, with regard to this exclusion of routine litigation, Instruction 5 to Item 103 includes a specific discussion of environmental litigation or other legal proceedings. The instruction provides that an administrative or judicial proceeding arising under any federal, state, or local provisions regulating the discharge of materials into the environment or principally for the purpose of protecting the environment are *not* “ordinary routine litigation incidental to the business.”

Such proceedings must be described if: (a) any such proceeding (or combined proceedings if they present largely the same issues) is material to the business or financial condition of the registrant; (b) any such proceeding (or combined proceedings if they present largely the same issues) involves primarily a claim for damages, or involves potential

monetary sanctions, capital expenditures, deferred charges, or charges to income and the amount involved exceeds 10% of the registrant’s and its consolidated subsidiaries’ current assets; or (c) a governmental authority is a party to the proceeding and the proceeding involves potential monetary sanctions, unless the registrant reasonably believes that the proceeding will not in fact result in monetary sanctions, or if the monetary sanctions, exclusive of interest and costs, are expected to amount to less than \$100,000. The Division of Corporation Finance’s Office of Chief Counsel has provided telephone guidance indicating that the reference in Instruction 5 to an “administrative or judicial proceeding arising under ‘local provisions’ is sufficiently broad to require disclosure of environmental actions brought by a foreign government.”⁸⁶

Item 105 (formerly Item 503(c)) of Regulation S-K: Risk Factors. The Commission recently moved the Risk Factor disclosure requirements from Item 503(c) to a new Item 105.⁸⁷ The amendment emphasized its principles-based approach that encourages companies to focus on the risks that are relevant to their own specific circumstances. Item 105 requires companies, when appropriate, to disclose under the caption “Risk Factors” a discussion of “the most significant factors that make an investment in the registrant or offering speculative or risky.” The item cautions against disclosures that present risks that “could apply generically to any registrant or any offering.”

Item 303 of Regulation S-K: Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A). Item 303 requires registrants to discuss their financial condition, changes in financial condition, and results of operations, providing the information as specified in paragraphs 303(a)(1) through (5). These items address the registrant’s (1) liquidity, (2) capital resources, (3) results of operations, (4) off balance sheet arrangements, and (5) contractual arrangements. Registrants also are required to disclose such other information that they believe to be

necessary to an understanding of their financial condition, changes in financial condition, and results of operations.⁸⁸

In the 2010 Interpretive Release, the Commission reinforced its earlier guidance that explained the objectives of the MD&A disclosure requirements. They are:

- to provide a narrative explanation of a registrant's financial statements that enables investors to see the registrant through the eyes of management
- to enhance the overall financial disclosure and provide the context within which financial information should be analyzed
- to provide information about the quality of, and potential variability of, a registrant's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance⁸⁹

The Commission emphasized the flexibility of its requirements in Item 303 and its objective that the disclosures “keep pace with the evolving nature of business trends without the need to continuously amend the text of the rule.”⁹⁰ While certain provisions of Item 303 set forth specific disclosure requirements, others are principles-based and “require management to apply the principles in the context of the registrant's particular circumstances.”⁹¹ The disclosures should be clear and identify management's view of the company's prospects and financial condition.

In this regard, registrants are required to disclose the “known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance.”⁹² The Commission noted that it has not quantified any specific future time period that must be considered in evaluating the events that might have a material effect on financial condition or operating performance. “As with any other judgment required by Item 303, the necessary time pe-

riod will depend on a registrant's particular circumstances and the particular trend, event or uncertainty under consideration.”⁹³

When assessing the materiality of any specific information, the registrant should consider both the probability and the magnitude of the event in light of the company's circumstances.⁹⁴ This two-part test requires the registrant to consider if the event is likely to materialize. If it is unlikely to do so, then no disclosure is required. If the registrant cannot make the determination that the event is unlikely to occur, then it must assess whether it would have a material effect on the company's financial condition and results of operations if it were to occur. This materiality analysis is intended to focus the disclosures on matters that are of particular importance to the company and to cull out less meaningful disclosures. “The effectiveness of MD&A decreases with the accumulation of unnecessary detail or duplicative or uninformative disclosure that obscures material information.”⁹⁵

Disclosure Requirements for Foreign Private Issuers. The 2010 Interpretive Release emphasized that its guidance applies to not only domestic issuers but also foreign private issuers, whose specific disclosure requirements derive from Regulation S-K (as to Securities Act disclosures in registration statements filed on Form F-1 or F-3) or Form 20-F⁹⁶ for Exchange Act reports and registration statements. The Commission noted that “most of the disclosure requirements applicable to domestic issuers under Regulation S-K that are most likely to require disclosure related to climate change have parallels under Form 20-F, although some of the requirements are not as prescriptive as the provisions applicable to domestic issuers.”⁹⁷ The Commission identified the following provisions of Form 20-F as ones specifically to consider when assessing whether a foreign private issuer must disclose climate change issues:

- Item 3.D (disclosure of material risks)
- Item 4.B.8 (disclosure of material effects of

- government regulation on the company's business)
- Item 4.D (disclosure of any environmental issues that might affect the company's use of assets)
 - Item 5 (explanation of factors that have affected the company's historical financial condition and results of operations and management's assessment of trends and factors that are expected to have a material effect on the company's future financial condition and results of operations)
 - Item 8.7.A (disclosure of legal or arbitration proceedings, including those brought by the government, that have had or might in the future have significant effects on the company's financial position or profitability)⁹⁸

2010 INTERPRETIVE RELEASE

The 2010 Interpretive Release provides guidance as to some of the ways in which climate change risks and opportunities might require disclosure under the reporting provisions discussed above. The examples provided are illustrative and not necessarily exhaustive.

Impact of Legislation, Regulation, and International Accords. Developments in foreign, federal, state, and local laws, rules, and regulations could trigger disclosure obligations under all of the provisions outlined above. The Commission identified some examples of pending legislation, including costs to purchase or benefits from selling carbon allowances pursuant to cap-and-trade systems; costs of improving facilities or equipment to reduce emissions in order to comply with regulatory limits on emissions; and financial impacts from increased or decreased demand for goods either directly due to regulatory changes or indirectly due to increases in costs of goods sold (e.g., due to the imposition of a carbon tax on certain products).

The Commission focused on regulations govern-

ing GHG emissions, specifically. Such regulations would require disclosure in the company's business description, pursuant to Item 101 of Regulation S-K if they would require the company to make material capital expenditures for environmental control facilities. If the laws or regulations led to material legal proceedings or threatened legal proceedings, they would trigger disclosure obligations under Item 103. Further, if the laws or regulations presented material risks for the registrant specific to the company and not merely generic risks applicable to all registrants, then risk factor disclosure would be required pursuant to Item 105. Finally, the Commission urged registrants to assess whether the laws or regulations are reasonably likely to have a material effect on the company's financial condition or results of operation, which would require MD&A disclosure under Item 303.

The Commission pointed out that companies should consider competitive benefits and other positive effects of new laws or rules as well as their negative effects. A registrant "should not limit its evaluation of disclosure of proposed laws only to negative consequences. Change in the law or in the business practices of some registrants in response to the law may provide new opportunities for the registrant. For example, if a 'cap and trade' type system is put in place, registrants may be able to profit from the sale of allowances if their emissions levels end up being below their emissions allotment."⁹⁹

Registrants must disclose the impact on their business of treaties and international accords related to climate change if they present a material risk or benefit to the company. If the registrant's business is reasonably likely to be affected by those agreements, the company must evaluate the possible impact and provide disclosures, as appropriate, in the company's business description and MD&A.

Indirect Consequences of Regulation or Business Trends. The Commission noted that various developments related to climate change could indirectly create new risks and opportunities for registrants that might trigger disclosure obligations. For example,

the developments could increase or decrease demand for the registrant's products or services or open new market opportunities or new competitive threats. In the context of GHG emissions, registrants whose businesses are materially impacted must consider the extent to which, for example, there might be a decreased demand for goods that have a high GHG intensity. Conversely, demand for goods that produce lower GHGs could increase. Demand for alternative energy could increase, and those supporting the production of carbon-based energy sources could see a reduction in demand.

The Commission also encouraged registrants to consider reputational impacts. If public opinion of a company's goods or services were materially affected by the perception that the company is a "good" or "bad" corporate citizen, the company should consider disclosure of that reputational effect. The Commission noted that, as always, registrants should consider their own facts and circumstances in evaluating the materiality of the indirect consequences of climate change events. When they are material, the company must consider what disclosure obligations are triggered, referring to the disclosure guidance provided, as described above. For example, the indirect consequences might require disclosure in MD&A to the extent they represent a material known trend or uncertainty impacting the company's financial condition or results of operations. If they present a material risk, they could drive risk factor disclosure. Even business description disclosure could be required if the registrant were, for example, to shift its business focus in response to changing competitive or reputational pressures.

Physical Impacts of Climate Change. The physical effects of climate change, such as flooding, hurricanes, rising sea levels, rising temperatures, or impaired access to water, could present threats to a company's operations that, if material, would require disclosure. The Commission cites a 2007 Government Accountability Office report indicating that, between 1980 and 2005, 88% of property losses paid

by insurers were related to weather.¹⁰⁰ If climate change exacerbates the incidence of severe weather, then it likely will be a reporting consideration for more registrants. Potential consequences of severe weather that the Commission cites include property damage and disruption to operations, including manufacturing operations and transport of products; financial and operational impacts due to disruptions to major business partners such as key customers or suppliers due to hurricanes or floods; increased insurance claims for insurance companies and reinsurance companies and higher premiums for companies with higher risks such as those in coastal areas; and decreased agricultural production and capacity in areas impacted by flooding or drought.¹⁰¹

PROPOSED MODIFICATIONS TO THE SEC REPORTING FRAMEWORK

Concept Release on Business and Financial Disclosure Required by Regulation S-K. On April 13, 2016, the Commission issued a concept release pursuant to the Commission's Disclosure Effectiveness Initiative (Concept Release).¹⁰² The Concept Release sought public comment broadly on modernizing the disclosure requirements in Regulation S-K. It also specifically sought comment on the disclosure requirements related to ESG issues. The Commission provided that the disclosure regime as it relates to ESG issues is essentially the same as it was in 1975, when the Commission last considered environmental and social disclosure matters.¹⁰³ However, the Commission observed 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."¹⁰⁴

The Concept Release solicited comments on a number of issues related to ESG disclosures. It queried whether line-item disclosure requirements for sustainability would be beneficial, or whether they might prompt disclosure of immaterial information. It invited comment on whether the Commission should draw on any of the existing

standards that currently frame voluntary sustainability disclosures and, if so, which standard should be used. It requested input on whether sustainability disclosures should appear in the documents filed with the Commission or whether registrants should make sustainability disclosures in stand-alone reports or on websites. It also sought comment on the challenges that registrants would face—including costs incurred—in preparing and providing enhanced ESG information.

The Concept Release received a significant response from commenters. An analysis by the SASB notes that the comments were disproportionately focused on sustainability disclosures, given the space allotted to the issue in the Concept Release. Out of the Concept Release's 92 pages (as published in the *Federal Register*), only four pages were devoted to sustainability disclosures. Yet according to the SASB, "the large majority of comment letters on the Concept Release addressed sustainability issues."¹⁰⁵ Specifically, of the 276 non-form comment letters, two-thirds addressed sustainability disclosures, with most of the letters supporting improved sustainability-related disclosures.¹⁰⁶ One comment letter pointedly declared that "the sustainability topic is clearly on the table at this point, and the Commission will sooner or later have to—and should—address it."¹⁰⁷

A resounding theme in the comments is that there is a need to improve the quality of ESG disclosures. As Keith Higgins, then the Director of the Division of Corporation Finance, has observed, "Many of the commenters found voluntary disclosures to be inconsistent, difficult to find, and often not comparable and lacking in context."¹⁰⁸

The SASB analysis concludes that the leading issue among those who commented on sustainability factors is climate change, with 51% of the sustainability-focused comment letters calling for improved climate change disclosures.¹⁰⁹ Other issues raised include access to and stewardship of water, land tenure rights, lobbying and political spend-

ing, diversity, gender pay equity, human rights, human capital management, sustainable palm oil, forestry, and supply-chain management.¹¹⁰ The top five topics discussed in the comment letters, in descending order, are: improved disclosure on climate change, improved disclosure of human rights and human capital issues, disclosure of political spending and lobbying, improved disclosure of diversity, and improved disclosure with regard to water.¹¹¹

Many of the comment letters stressed the importance of adhering to materiality as the North Star in determining what information should be disclosed. For example, a letter submitted by the Federal Regulation of Securities Committee of the American Bar Association (ABA) Business Law Section provided that the Committee agrees with "the Commission's long-standing position that disclosure relating to environmental and other matters of similar concern should not be required of all registrants unless, under the particular facts and circumstances, such matters are important to the reasonable investor (i.e., material information)."¹¹² This materiality assessment is particularly significant in the context of ESG disclosures when the issues are varied and their impact is company-specific. According to the Committee, "ESG issues encompass a wide and diverse range of issues from climate change to sustainable business practices to human capital management. Even with a particular topic, such as the impacts of climate change, the issues will vary significantly from industry to industry and from registrant to registrant."¹¹³

The comment letters were divided as to whether the Commission should adopt line-item disclosure requirements related to sustainability, with 26% of the sustainability-focused comment letters supporting line-item disclosure requirements and 21% opposing such requirements.¹¹⁴ The SASB itself opposed a line-item disclosure requirement. "Sustainability issues are not material for all companies, and when they are material, they manifest in unique ways and require industry-specific metrics.

Requiring generally applicable line-item disclosures would result in additional corporate reporting burden and disclosure of a large volume of information that is immaterial to investors.”¹¹⁵ Rather, the SASB advocated for the adoption of a market standard for industry-wide sustainability information calibrated to the specific and evolving sustainability issues that are material within different industries. The ABA Committee letter, similarly, expressed concern over mandatory line-item disclosures: “Line-item requirements may result in a significant number of registrants being required to make immaterial disclosure that is costly to prepare and not necessarily helpful to investors.”¹¹⁶ A comment letter submitted by the Nasdaq Stock Market (Nasdaq) similarly expressed the stock exchange’s preference for a principles-based disclosure system rather than rules-based, line-item disclosure requirements: “While rules-based disclosure may facilitate comparability of information provided by public companies, a forced template regime increases the cost and complexity of producing the reports. Nasdaq believes that principles-based disclosure grounded in materiality allows companies the degree of flexibility needed to provide investors with the proper amount and mix of information . . . (Applying a materiality analysis) investors are assured that unnecessary detail does not obscure important disclosure, while at the same time, all material information is disclosed.”¹¹⁷

The US Chamber of Commerce articulated the concern, echoed by other commenters, that prescriptive disclosure requirements can force companies to disclose information that is immaterial and unhelpful to investors, and that can have the effect of obscuring material information that investors do need. “Information overload strikes a blow to the effectiveness of the disclosure regime that the SEC administers,” the Chamber stated. “The essential problem is that investors become inundated with information that is not useful, making it difficult to identify important information about a business.” Instead, “we must be vigilant in applying the test of materiality.”¹¹⁸

PRI’s comment letter, consistent with many others, embraced materiality as the appropriate standard for assessing what should be disclosed but took a different position with regard to prescriptive versus principles-based disclosure obligations. “The existing materiality standard used by the Commission is familiar to the investment community and ought to be maintained,” PRI stated. “The Commission should continue to use a mix of principles-based and prescriptive or rules-based disclosures.”¹¹⁹ Like many others, the PRI comment letter expressed concern over generic disclosures that are costly to produce and unhelpful to investors: “The production and analysis of disclosures both have significant costs associated with them, particularly where the information produced has a low signal to noise ratio, is immaterial to an assessment of the business or generic in nature.”¹²⁰

Rather than advocate for a pure principles-based disclosure framework as some commenters did, the PRI proposed that the Commission require inclusion of ESG data in the annual report with connection back to the company’s core business. The ESG data would be subject to assurance, consistent with financial disclosures. Registrants would be required to report “using common performance metrics to allow for comparability, in particular, comparability by industry, portfolio and across time-series. The Commission should codify industry and sector specific KPIs for ESG factors within Regulation S-K.”¹²¹ This idea of tying disclosures to a common industry-specific framework echoes the SASB comment letter. While the SASB letter opposed line-item disclosure requirements, it advocated for industry-specific sustainability guidelines to help companies identify the material issues facing their businesses. The SASB asked the Commission to acknowledge its standards as an acceptable disclosure framework for use by companies preparing their SEC filings.¹²²

Notwithstanding some commenters’ call for more prescriptive disclosure requirements, the Commission and its staff appear to favor continued adherence to a principles-based approach. William Hin-

man, the Director of the Division of Corporation Finance, made the case for a principles-based approach in a March 2019 speech: “The very breadth of (ESG) issues illustrates the importance of a flexible disclosure regime designed to elicit material, decision-useful information on a company-specific basis.”¹²³ Hinman also indicated his view that the dynamic nature of ESG issues militates in favor of the SEC’s waiting for the market to settle before it makes any significant modifications to the disclosure requirements: “We recognize that market participants have raised questions about the sufficiency of sustainability disclosures, and I think this is a complicated issue . . . We hear differing views on whether disclosure requirements should be principles-based or prescriptive, and whether they should utilize a specific set of reporting standards to enhance comparability. So it appears to me that the market is still evaluating what, if any, additional disclosure on these topics would provide consistently material and useful information.”¹²⁴ The GAO issued a report to Congress in February 2018 concluding that the SEC had taken appropriate steps to clarify its disclosure requirements with regard to climate-related risks.¹²⁵

August 2019 Proposed Amendments to Items 101, 103 and 105 of Regulation S-K. On August 8, 2019, the Commission issued proposed rule amendments to update Items 101, 103 and 105 of Regulation S-K.¹²⁶ The release refers extensively to the 2016 Concept Release. It leaves some of the concerns expressed in comment letters unresolved while addressing certain others. The proposed rules do not address the comments that advocate for application of the SASB standards. They largely maintain the status quo with regard to environmental disclosures, while encouraging registrants to calibrate their disclosures based on their materiality assessments. The proposals would expand the disclosure requirements related to human capital in recognition of the importance of intangible assets to companies’ value.

The release explains that the proposed amendments are designed to improve the readability of

disclosure documents, reduce repetition of information, and discourage disclosure of information that is not material. The release proposes a more principles-based approach to disclosures in Items 101 (Description of Business) and 105 (Risk Factors) and a prescriptive approach to Item 103 (Legal Proceedings). The Commission explains that the proposed principles-based approach to Items 101 and 105 reflects its concern that the current disclosure requirements might not elicit disclosures that are material to all companies. The release does not propose amendments to Item 303 (MD&A).

The proposed amendments would retain many of the specific line item disclosure requirements in Item 101 with an overlay of materiality that would clarify that disclosure is not required of immaterial information. The release also makes clear that information material to the business should be disclosed even if not specifically enumerated in Item 101.

The revised rules would retain the requirement in Item 101(c) to disclose the source and availability of raw materials in recognition that raw materials are fundamental to businesses that depend on them. However, businesses for which the availability of raw materials is not material would not be required to disclose information concerning raw materials.

The proposals would retain the current requirement in Item 101(c) of disclosure of the material effects of compliance with material environmental laws and would expand the item to include compliance with material government regulations generally. The proposal would retain the requirement for disclosure of material estimated capital expenditures for environmental control facilities.

The revised rules would not require disclosure of additional specific expenditures related to environmental compliance as proposed by some commenters on the 2016 Concept Release. “We believe that a more principles-based approach would permit a registrant to tailor its disclosure by focusing on the effects of environmental compliance that are material to its particular business.”¹²⁷ Further, “Our

proposed approach is consistent with the views of several commenters that supported the retention of Item 101(c)'s environmental compliance provisions while opposing its expansion."¹²⁸ Not all of the Commissioners were so enthusiastic about this approach. Commissioners Jackson and Lee expressed their concern "about the shift toward a principles-based approach to disclosure and the absence of the topic of climate risk." Further, "Our concern is that the proposal's principles-based approach will fail to give American investors the information they need about the companies they own."¹²⁹ Commissioners Jackson and Lee encouraged commenters to step forward to help to ensure that Regulation S-K encourages transparency and meaningful, comparable disclosures.

The proposed revisions to Item 103 would, among other things, retain the existing required disclosure of any proceeding under environmental laws to which a governmental authority is party. However, the carve-out in Instruction 5.C for matters as to which the registrant reasonably believes it will not be subject to sanctions of \$100,000 or more would be modified and the threshold increased to \$300,000 to reflect inflation.

The release proposes new human capital disclosures by expanding Item 101(c)(1)(xiii), which currently requires disclosure of the number of employees employed by the registrant. Many commenters in response to the 2016 Concept Release recommended expanding the existing requirement to help investors understand the risks of potential material labor and human rights violations.¹³⁰ The Commission emphasizes the significance of human capital as an important intangible asset.

Today, intangible assets represent an essential resource for many companies. Because human capital may represent an important resource and driver of performance for certain companies, and as part of our efforts to modernize disclosure, we propose to amend Item 101(c) to refocus registrants' human capital resources disclosures. Specifically,

*we propose replacing the current requirement to disclose the number of employees with a requirement to disclose a description of the registrant's human capital resources, including in such description any human capital measures or objectives that management focuses on in managing the business, to the extent such disclosures would be material to an understanding of the registrant's business.*¹³¹

The proposed new disclosure provision would require "a description of the registrant's human capital resources, including in such description any human capital measures or objectives that management focuses on in managing the business (such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the attraction, development and retention of personnel)."¹³² The release solicits comment as to, among other matters, whether the new disclosure requirement should include prescriptive disclosure provisions or remain principles-based, as proposed.

To be continued in the August Report

ENDNOTES:

¹2019 Status Report, Task Force on Climate-Related Financial Disclosures (June 2019), available at <https://www.fsb-tcf.org/publications/tcf-2019-status-report/>.

²Sustainability Accounting Standards Board, "Dead Cobras and Faberge Eggs: Unlocking the Potential of ESG Data" (2018), available at <https://library.sasb.org/dead-cobras-faberge-eggs-unlocking-the-potential-of-esg-data/>. For a further discussion of SASB and its work, see *Voluntary Disclosure Frameworks*: Sustainability Accounting Standards Board, below.

³Dickon Pinner, "Summit Recap Sustainability at a Tipping Point," McKinsey Insights, <https://www.mckinsey.com/business-functions/sustainability/our-insights/sustainability-blog/summit-recap-sustainability-at-a-tipping-point> (May 30, 2019).

⁴Dickon Pinner, "Summit Recap Sustainability at a Tipping Point," McKinsey Insights, <https://www.mckinsey.com/business-functions/sustainability/our-insights/sustainability-blog/summit-recap-sustainability-at-a-tipping-point> (May 30, 2019).

⁵World Economic Forum, in partnership with Marsh & McLennan Companies and Zurich Insurance Group, “The Global Risks Report 2019,” available at http://www3.weforum.org/docs/WEF_Global_Risks_Report_2019.pdf.

⁶World Economic Forum, in partnership with Marsh & McLennan Companies and Zurich Insurance Group, “The Global Risks Report 2019,” available at http://www3.weforum.org/docs/WEF_Global_Risks_Report_2019.pdf.

⁷US Chamber of Commerce Foundation, “Corporate Sustainability Reporting: Past, Present, Future” (November 2018).

⁸US Chamber of Commerce Foundation, “Corporate Sustainability Reporting: Past, Present, Future” (November 2018), at 3.

⁹UN Principles for Responsible Investment, www.unpri.org. PRI signatories subscribe to six principles that guide the integration of ESG into the investment process:

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Principle 4: We will promote acceptance and implementation of the Principles within the investment community.

Principle 5: We will work together to enhance our effectiveness in implementing the Principles.

Principle 6: We will each report on our activities and progress toward implementing the Principles.

¹⁰Global Sustainable Investment Alliance, “2018 Global Sustainable Investment Review,” available at http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf. The Review defines sustainable investing as investment practices that apply any of the following strategies: (1) negative/exclusionary screening, (2) positive/best-in-class screening, (3) norms-based screening, (4) ESG integration, (5) sustainability themed investing, (6) impact/community investing, and (7) corporate engagement and shareholder action.

¹¹Global Sustainable Investment Alliance, “2018 Global Sustainable Investment Review,” available at http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf.

¹² <https://www.blackrock.com/ch/individual/en/themes/sustainable-investing#esg-integration>.

¹³US Chamber of Commerce Foundation, “Corporate Sustainability Reporting: Past, Present, Future” (November 2018), at 5.

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⁶¹Silda Wall Spitzer and John Mandyck, “What Boards Need to Know About Sustainability Ratings,” *Harvard Business Review* (May 30, 2019), available at <https://hbr.org/2019/05/what-boards-need-to-know-about-sustainability-ratings>.

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⁶³Morgan Stanley, *supra* note 18, at p. 14.

⁶⁴Thomas Singer, Ajuj Saush, and Anke Schrader, “Sustainability Practices 2018 Edition: Trends in Corporate Sustainability Reporting in North America, Europe, and Asia-Pacific” The Conference Board, available at <https://www.conference-board.org/sustainability-practices/>.

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⁷⁷17 CFR § 229.

⁷⁸Additionally, Regulation S-X governs the financial statement disclosure requirements. See 17 CFR § 229.

⁷⁹17 CFR § 229.101.

⁸⁰17 CFR § 229.103.

⁸¹17 CFR § 229.105.

⁸²17 CFR § 229.303.

⁸³17 CFR § 230.408 and 17 CFR § 240.12b-20.

⁸⁴Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106; 34-61469; 17 CFR Parts 211, 231, 241 (February 8, 2010).

⁸⁵17 CFR § 229.101(c)(1)(xii).

⁸⁶SEC Division of Corporation Finance, Manual of Publicly Available Telephone Interpretations, Section I, Question #7, available at https://www.sec.gov/interps/telephone/cftelinterps_regs-k.pdf; See also Division of Corporation Finance Compliance and Disclosure Interpretation Question 105.02 (updated February 6, 2019), available at <https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm>.

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⁹⁰Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106; 34-61469; 17 CFR Parts 211, 231, 241 (February 8, 2010), at 16.

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⁹³Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106; 34-61469; 17 CFR Parts 211, 231, 241 (February 8, 2010), at 17.

⁹⁴*Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

⁹⁵Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106; 34-61469; 17 CFR Parts 211, 231, 241 (February 8, 2010), at 18, citing 2003 Release, *supra* note 89.

⁹⁶17 CFR § 249.220f.

⁹⁷Commission Guidance Regarding Disclosure

Related to Climate Change, Release Nos. 33-9106; 34-61469; 17 CFR Parts 211, 231, 241 (February 8, 2010), at 20.

⁹⁸Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106; 34-61469; 17 CFR Parts 211, 231, 241 (February 8, 2010), at 20-21.

⁹⁹Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106; 34-61469; 17 CFR Parts 211, 231, 241 (February 8, 2010), at 23.

¹⁰⁰Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106; 34-61469; 17 CFR Parts 211, 231, 241 (February 8, 2010), at 26.

¹⁰¹Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106; 34-61469; 17 CFR Parts 211, 231, 241 (February 8, 2010), at 27.

¹⁰²SEC Concept Release, “Business and Financial Disclosure Required by Regulation S-K,” Release No. 33-10064; 34-77599 (April 13, 2016), available at <https://www.sec.gov/rules/concept/2016/33-10064.pdf>. The SEC’s Spotlight on Disclosure Effectiveness website explains the Disclosure Effectiveness Initiative: “The Division of Corporation Finance is reviewing the disclosure requirements in Regulation S-K and Regulation S-X, which provides requirements for financial statements, and is considering ways to improve the disclosure regime for the benefit of both companies and investors. The goal is to comprehensively review the requirements and make recommendations on how to update them to facilitate timely, material disclosure by companies and shareholders’ access to that information.” See <https://www.sec.gov/spotlight/disclosure-effectiveness.shtml>.

¹⁰³SEC Concept Release, “Business and Financial Disclosure Required by Regulation S-K,” Release No. 33-10064; 34-77599 (April 13, 2016), available at <https://www.sec.gov/rules/concept/2016/33-10064.pdf>, at 209, citing “Environmental and Social Disclosure,” SEC Release No. 33-5627, 40 Fed. Reg. 51656 (Nov. 6, 1975). This release was the subject of litigation and a measure of handwriting by the SEC, which might account, at least in part, for the decades-long stasis on environmental disclosure requirements. See *Natural Resources Defense Council v. SEC*, 606 F.2d 1031 (D.C. Cir. 1979). The case addressed an NRDC petition that asked the SEC to adopt rules requiring disclosure of environmental and equal opportunity practices. After seven

years of proceedings, the SEC declined to adopt the proposed rules, leading to the NRDC's suit in which the SEC ultimately prevailed at on appeal.

¹⁰⁴SEC Concept Release, "Business and Financial Disclosure Required by Regulation S-K," Release No. 33-10064; 34-77599 (April 13, 2016), available at <https://www.sec.gov/rules/concept/2016/33-10064.pdf>, at 211.

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¹²⁵United States Government Accountability Office Report to Congressional Requesters, “Climate-Related Risks: SEC Has Taken Steps to Clarify Disclosure Requirements,” GAO 18-188 (February 2018), available at <https://www.gao.gov/assets/700/690197.pdf>.

¹²⁶SEC Proposed Rule, “Modernization of Regulation S-K Items 101, 103, and 105,” SEC Release Nos. 33-10668, 34-86614 (August 8, 2019).

¹²⁷SEC Proposed Rule, “Modernization of Regulation S-K Items 101, 103, and 105,” SEC Release Nos. 33-10668, 34-86614 (August 8, 2019), at 43.

¹²⁸SEC Proposed Rule, “Modernization of Regulation S-K Items 101, 103, and 105,” SEC Release

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¹²⁹Joint Statement of Commissioners Robert J. Jackson, Jr. and Allison Herren Lee on Proposed Changes to Regulation S-K (August 27, 2019), available at <https://www.sec.gov/news/public-statement/statement-jackson-lee-082719>.

¹³⁰SEC Proposed Rule, “Modernization of Regulation S-K Items 101, 103, and 105,” SEC Release Nos. 33-10668, 34-86614 (August 8, 2019), at 44-45.

¹³¹SEC Proposed Rule, “Modernization of Regulation S-K Items 101, 103, and 105,” SEC Release Nos. 33-10668, 34-86614 (August 8, 2019), at 48. The Commission’s focus on the growing value of intangible assets echoes the report of the Conference Board’s Integrated Reporting Working Group, discussed below.

¹³²SEC Proposed Rule, “Modernization of Regulation S-K Items 101, 103, and 105,” SEC Release Nos. 33-10668, 34-86614 (August 8, 2019), at 110.

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