June 1, 2020

SEC Investor Advisory Committee Recommends Updating Public Company Reporting Requirements to Include ESG Factors

At the May 21 meeting of the SEC's Investor Advisory Committee, the Committee approved the recommendation by its Investor-as-Owner Subcommittee that the SEC begin in earnest an effort to update issuer reporting requirements to specifically include ESG factors. The recommendation adds to the growing chorus calling for additional mandatory ESG disclosures. In this Alert, we discuss the Subcommittee's report and share some related thoughts on the evolving ESG disclosure landscape.

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The Debate over ESG Disclosure

As noted by the Subcommittee, the debate over whether and what ESG-related disclosures should be mandated by the SEC is not new. This debate has been going on since the 1970s. However, the debate has intensified over the last few years with increasing integration by mainstream investors of ESG factors into investment and voting decisions. Some of the interrelated drivers behind ESG integration by managers include studies showing a correlation between investment return and an issuer's management of ESG factors, asset owner requirements, the growth in assets under management at sustainability-focused funds and foreign ESG integration and disclosure requirements applicable to managers based outside of the United States. The growth in the number of signatories to the Principles for Responsible Investment reflects the increasing focus on ESG integration by asset owners and managers. According to PRI, it now has approximately 2,300 signatories with approximately $80 trillion in assets under management.

Proponents of enhanced ESG disclosure requirements believe that the current issuer disclosure regime does not adequately address ESG information needs of investors. Bills introduced or proposed over the last couple of years pertaining to ESG broadly or specific ESG issues that would create new disclosure requirements for public companies include the Business Supply Chain Transparency on Trafficking and Slavery Act (2018); Climate Risk Disclosure Act (2019); ESG Disclosure Simplification Act (2019); Corporate Human Rights Risk Assessment, Prevention and Mitigation Act (2019); Shareholder Protection Act (2019); and Disclosure of Tax Havens and Offshoring Act (2019). In addition, as required by the Dodd-Frank Act, during December 2019, the SEC proposed a new resource extraction payments disclosure rule, which is described in our Alert here.

On the other side of the coin, the view is that issuers already are required to disclose material ESG information through the SEC's current disclosure regime, including Item 101 (Description of Business), Item 103 (Legal Proceedings), Item 105 (Risk Factors) and Item 303 (MD&A) of Regulation S-K. And, although there are differing views on whether the information required to be disclosed is material to investors, there also are issue-specific socially-driven disclosure requirements pertaining to conflict minerals (Rule 13p-1 and Form SD) and pay ratio (Item 402 of Regulation S-K).

For a further overview of existing and proposed ESG-related disclosure requirements, see our Article here prepared for Practising Law Institute's 51st Annual Institute on Securities Regulation.

The Subcommittee's Recommendation

The Dodd-Frank Act established the Investor Advisory Committee to advise the SEC on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure and initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace. The Dodd-Frank Act authorizes the Committee to submit findings and recommendations for review and consideration by the SEC.

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The members of the Investor-as-Owner Subcommittee were John Coates (Chair) (John F. Cogan Jr. Professor of Law and Economics at Harvard Law School and Research Director of the Center on the Legal Profession), Damon Silvers (Vice Chair) (Director of Policy and Special Counsel, AFL-CIO), Allison Bennington (Former Partner and Chief Global Affairs Officer, ValueAct Capital), Anne Simpson (Interim Managing Investment Director, California Public Employees' Retirement System) and Heidi Stam (Former Managing Director and General Counsel (Retired), Vanguard).

The Subcommittee recommended that the SEC begin in earnest an effort to update the reporting requirements for issuers to include material, decision-useful ESG factors. The Subcommittee provided the following reasons for its recommendation:

- *Investors require reliable, material ESG information upon which to base investment and voting decisions.*

  According to the Subcommittee, investors are not being served or protected by the piecemeal, ad-hoc, inconsistent information currently in the mix.

- *Issuers should directly provide material information to the market relating to ESG issues used by investors to make investment and voting decisions.*

  The Subcommittee noted that issuers are not always the primary source of the ESG data being used by investors to make investment and voting decisions, with a patchwork of information in the mix and third-party data sources filling the void. The Subcommittee characterized the information in the market as inconsistent and unreliable, and expressed the view that investors and third-party data providers should have accurate and comparable primary-source information deemed by the issuer to be material upon which to base their analysis, and that consistent standards and oversight should govern disclosure of this data.

- *Requiring disclosure of material ESG data and information will level the playing field between issuers.*

  The Subcommittee expressed the view that smaller issuers, or those that are capital constrained, can be at a disadvantage for investment since they are not as able to provide the same amount or level of detail of ESG-related data as larger issuers. According to the Subcommittee, SEC reporting obligations that require a single standard of material, decision-useful information based upon data that companies already use to make their business decisions would level the playing field among issuers.

- *To ensure the flow of capital to the U.S. markets and to U.S. issuers of all sizes.*

  The Subcommittee noted that many investors view material ESG factors as critical drivers of risks and returns in their investment decisions, both in the short-term and the long-term. According to the Subcommittee, requiring disclosure of this information by issuers will facilitate the flow of capital to U.S. issuers of all sizes from investors with or without ESG-related investment mandates. The Subcommittee also expressed the view that, in time, without the availability of reliable ESG-related material information for all U.S. issuers, capital may be redirected by investors to companies outside the United States that are required by non-U.S. regulators to report ESG data.

- *The United States should take the lead on ESG disclosure.*

  The Subcommittee recommends that the SEC take the lead on this issue by establishing a principles-based framework that will provide the issuer-specific material, decision-useful information that investors require to make investment and voting decisions. The Subcommittee goes on to note that this disclosure should be based upon the same information that companies use to make their own business decisions. The Subcommittee

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expressed the concern that, if the SEC does not take the lead, it is highly likely that other jurisdictions will impose standards in the next few years that U.S. issuers will directly or indirectly be bound to follow.

Chairman Clayton's and Commissioners' Views

In public statements issued in connection with the Investor Advisory Committee meeting, Chairman Jay Clayton and Commissioner Hester Peirce expressed skepticism regarding ESG-specific disclosure requirements.

In his public statement, Chairman Clayton noted that he believes "E, S and G are quite different baskets of disclosure matters and that lumping them together diminishes the usefulness, including investor understanding, of such disclosures." Chairman Clayton had previously articulated this view, which, as he noted, was not new to the Investor Advisory Committee.

In her statement, Commissioner Peirce expressed the view that the existing disclosure regime is sufficient to require ESG-related disclosure where such information is material to investors. She noted that she too is concerned about "multiple ESG data providers bombarding issuers with questionnaire after questionnaire in order to produce assessments of questionable value." However, she believes a new SEC disclosure framework for ESG information "seems an unnecessary response when our existing securities disclosure framework is very good at handling all types of material information."

But, not all of the Commissioners are opposed to ESG-specific disclosure requirements. Commissioner Allison Herren Lee indicated in a statement issued in January 2020 that she is supportive of enhanced requirements regarding ESG-specific disclosures, and in particular, climate change disclosure, given investor demand for this information and her view that existing requirements have not resulted in consistent, reliable and comparable disclosure for investors.

In addition, underscoring that there are differing views on this topic, not all members of the Investor Advisory Committee were supportive of the recommendation. Four members of the IAC voted against the recommendation, with thirteen voting in favor (and four abstaining).

A Half-Dozen Parting Thoughts for Issuers

The Subcommittee's recommendation is not expected to lead to a shift in the SEC's approach to ESG disclosure. But even in the absence of broader-based ESG disclosure requirements for issuers, a substantial number of issuers are enhancing and rethinking their ESG disclosures and related compliance practices. An exhaustive discussion of these trends is beyond the scope of this Alert, but, expanding on some of the topics and concepts discussed in the Subcommittee's report, we highlight the following:

SASB and TCFD Continue to Gain Traction. The Subcommittee notes the lack of consistent, comparable, decision-useful ESG information in the marketplace. This has been a significant issue for both investors and issuers. Although the Subcommittee did not recommend or endorse a particular disclosure standard, the Subcommittee referenced, among others, the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD).

SASB has developed standards for 77 industries that identify the minimal set of financially material sustainability topics and their associated metrics for the typical company in each industry. The standards contain both quantitative and qualitative disclosure metrics. The TCFD recommendations are centered around four elements: (1) governance; (2) strategy; (3) risk management; and (4) metrics and targets. The TCFD recommendations are complementary with the SASB standards.

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Since the beginning of the year, we have seen a significant uptick in issuer interest in SASB and TCFD. The trigger for many issuers was BlackRock's Larry Fink's January 2020 letter to CEOs. In his annual letter, Larry Fink asked the companies in which BlackRock invests to publish disclosure in line with industry-specific SASB guidelines by year-end (or disclose a similar set of data in a way relevant to their particular business) and disclose climate-related risks in line with the TCFD's recommendations. State Street, Vanguard and other leading managers also have called on companies to align their ESG disclosures with the SASB standards and TCFD recommendations. Due to the COVID-19 pandemic, many companies are not as far along in their adoption of SASB and TCFD as they had planned to be, but we are nevertheless seeing significant momentum in this regard and expect a substantially greater number of companies to publish SASB- and TCFD-aligned ESG disclosures before the 2021 proxy season.

ESG Messaging Is Starting to Become More Targeted. As noted by the Subcommittee, issuers communicate ESG-related information through various channels. These communications often fall short, since many issuers take a one-size-fits-all approach, rather than tailoring their communications strategy to the particular stakeholder constituencies consuming the information. However, as issuers are gaining a better understanding of the information their stakeholder constituencies care about and how they consume that information, we are starting to see more targeted ESG messaging by issuers.

Companies Are Getting Better at Managing ESG Survey Fatigue. As also noted by the Subcommittee, the plethora of ESG data providers, all with different standards and criteria, has led to a significant burden on issuers, with some providers requesting completion of lengthy questionnaires that require significant time and effort. As issuers gain a better understanding of how investors are using ESG information, they also are starting to become more strategic in their approach to responding to ESG-related surveys and other information requests.

ESG Disclosure Practices are Converging Globally. Especially for larger issuers, ESG disclosures are not determined solely by where they are listed. Global convergence is being driven by large global asset owners and asset managers, proxy advisors and data analytics providers, among others.

We expect this convergence to continue. Public companies across jurisdictions are managing to many of the same or similar voluntary ESG standards, frameworks and guidelines. For example, the Global Reporting Initiative standards already have widespread global buy-in and SASB and TCFD similarly are seeing adoption globally. Stock exchanges in North America, Europe and Asia also have published ESG disclosure guidance that shares many substantive similarities. In addition, although still in the early stages, integrated reporting is gaining traction across several markets.

As noted by the Subcommittee, the call for mandatory ESG disclosure by issuers is not limited to the United States. The EU Non-financial Reporting Directive requires disclosure by EU-listed companies pertaining to environmental protection, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery matters and diversity. As part of the European Green Deal, the European Commission is reviewing the NFRD as part of its strategy to strengthen the foundations for sustainable investment. Although mandatory ESG disclosures are jurisdiction-specific, we are seeing these influence voluntary disclosures by issuers in other jurisdictions. If EU public companies are required to make more robust non-financial disclosures, those also will, over time, influence voluntary U.S. ESG disclosure practices.

Mandatory ESG Disclosures Applicable to U.S.-based Companies Will Continue to Increase. Even in the absence of SEC rulemaking, ESG disclosure requirements applicable to U.S.-based companies will continue to increase. For example, globally, there is likely to be a significant increase over the next several years in mandatory human rights disclosures, with legislation pending, proposed or under discussion in several countries. Some of these developments are discussed in our earlier Alerts here, here, here and here. Many of these requirements will create disclosure obligations for U.S.-based multinationals.

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Even with More Regulation, Most ESG Disclosures Will Continue to be Voluntary, but That Doesn't Mean They Don't Present Liability Risks. Notwithstanding the anticipated increase in certain mandatory ESG disclosures, most disclosures will continue to be voluntary in nature and sit outside of regulatory filings, given the wide range of topics under the ESG umbrella and the wide range of stakeholders for whom they are intended. However, as third-party scrutiny of voluntary ESG disclosures continues to grow, liability risks associated with these disclosures continue to increase across several jurisdictions. In recognition of these risks, many companies are enhancing oversight of their voluntary ESG disclosures, and we expect the involvement of legal and compliance personnel in voluntary ESG disclosures to continue to expand.

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