CORPORATE GOVERNANCE

Analysis

Sustainability in the Spotlight

In their Corporate Governance column, David A. Katz and Laura A. McIntosh discuss a governance initiative that, if successful, ultimately could have two significant effects on the ESG disclosure landscape: It may help generate a consensus as to common disclosure standards and, more importantly, it may increase the relevance of ESG disclosures to investors by heightening the quality, consistency, and impact of the information provided.

By **David A. Katz and Laura A. McIntosh** | January 22, 2020 at 12:49 PM

David A. Katz and Laura McIntosh. Courtesy photos

Sustainability is back in the headlines in the corporate world in the wake of BlackRock's recent communications to CEOs and clients. In founder Lawrence D. Fink's 2020 letter to chief executives, Mr. Fink predicts that the long-term, structural effects of climate change are likely to transform the financial markets, leading to "a fundamental reshaping of finance" and "a significant reallocation of capital." And in its 2020 letter to clients, BlackRock announces: "Because sustainable investment options have the potential to offer clients better outcomes, we are making sustainability integral to the way BlackRock manages risk, constructs portfolios, designs products, and engages with companies. **We believe that sustainability should be our new standard for investing.**"

Accordingly, BlackRock is requesting that companies produce significant ESG disclosures by the end of 2020. Specifically, while acknowledging that no framework is perfect, Mr. Fink calls for sustainability disclosures in conformance with the industry-specific guidelines issued by the Sustainability Accounting Standards Board (SASB) and climate-related risk disclosures that follow the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD). Mr. Fink's letter warns—in bold type—that noncompliance may result in BlackRock's voting against or withholding votes from management and board members.

BlackRock, fiduciary of nearly $7 trillion in assets under management, is an enormously powerful force in corporate America. This governance initiative, if successful, ultimately could have two significant effects on the ESG disclosure landscape: It may help generate a consensus as to common disclosure standards and, more importantly, it may increase the relevance of ESG disclosures to investors by heightening the quality, consistency, and impact of the information provided.

The ESG Disclosure Landscape

The current disclosure landscape for ESG matters is market-driven and fragmented. There is clearly a growing demand for ESG disclosure, which (with a few specific exceptions) is not currently mandated by the Securities and Exchange Commission unless, under the particular facts and circumstances, the disclosure would be material. In 2016, the SEC's Disclosure Effectiveness Initiative sought public comment as to whether the SEC should expand the business and financial disclosure requirements in Regulation S-K to include sustainability, among other issues. While the 2016 SEC initiative did not result in additional disclosure requirements, investors and activists have made use of Exchange Act Rule 14a-8 to include in proxy statements shareholder proposals requesting ESG disclosure. These shareholder proposals have grown in number, scope, and popularity in recent years. The 2019 proxy season saw noteworthy and large-scale shareholder initiatives relating to climate risks and environmental and social impact, and it is likely this trend will continue in 2020. In addition, investor interest in ESG issues has prompted companies to produce stand-alone sustainability reports, which are often lengthy and detailed. Tesla, for example, published its first "impact report" in April 2019 discussing product and operational impact, supply chain, and the company's focus on employees, culture, governance, and sustainability.

In the absence of federal ESG disclosure requirements, there is a wide array of independently generated disclosure standards. The Global Reporting Initiative (GRI) standards, the first worldwide standards for sustainability reporting, are in widespread use internationally. GRI's Sustainability Reporting Standards are designed to "help businesses, governments and other organizations understand and communicate the impact of business on critical sustainability issues." While the GRI standards are geared toward sustainability reports, GRI is also working toward "integrated reporting," in which "sustainability metrics (based on a multi-stakeholder approach)" are incorporated into financial reports.

The Sustainability Accounting Standards Board (SASB), endorsed by Mr. Fink as providing "a clear set of standards for reporting sustainability information across a wide range of issues," already takes the integrated reporting approach. According to the SASB, its standards "focus on known trends and uncertainties that are reasonably likely to affect the financial condition or operating performance of a company and therefore would warrant disclosure under Regulation S-K." The SASB standards "are designed to improve the effectiveness and comparability of corporate disclosure on material environmental, social, and governance factors in SEC filings" and have been recognized by the European Commission as suitable for companies providing information to investors in compliance with European Union requirements. Mr. Fink's 2020 letter should provide the SASB standards with momentum towards becoming the consensus industry-specific disclosure regime, at least in the United States, if not globally.

For disclosures regarding climate-related risks, BlackRock endorses the framework of the Task Force on Climate-Related Financial Disclosures (TCFD), a working group established by the Financial Stability Board in 2015. The TCFD's 2017 report put forth four broadly applicable recommendations for integrated reporting of climate-related risks in the areas of governance, strategy, risk management, and metrics and targets. The TCFD recommended that these disclosures be generated through internal governance processes similar to those used for financial reporting and that the information be included in annual public financial filings. BlackRock's updated stewardship guidance regarding climate risk and SASB- and TCFD-aligned reporting, which was released simultaneously with Mr. Fink's 2020 letter, conforms closely to the guidance published by SASB and the Climate Disclosure Standards Board, including their joint TCFD Implementation Guide.

BlackRock's wide sphere of influence means that its ESG disclosure initiative is likely to have a significant effect in conforming U.S. public company disclosures to the SASB standards and TCFD recommendations. These SASB and TCFD initiatives are now positioned to be the dominant protocols in ESG disclosure in the United States and possibly abroad. Regardless of how closely an individual company follows them, it is likely that investors will expect management and directors of public companies to be conversant with the SASB and TCFD approach to industry-specific sustainability issues and climate-related risks.

BlackRock has made clear that it will use its considerable voting power to enforce its request for ESG disclosure: "Last year BlackRock voted against or withheld votes from 4,800 directors at 2,700 different companies. Where we feel companies and boards are not producing effective sustainability disclosures or implementing frameworks for managing these issues, we will hold board members accountable … . [W]e will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them." It is likely that Rule 14a-8 shareholder proposals seeking ESG reporting will receive greater investor support where companies have not produced or committed to these disclosures.

Meaningful changes in the quality and quantity of ESG disclosures will not happen in one fiscal year, but BlackRock has accelerated the process and provided focal points. The more that sustainability and climate-related disclosures are based upon consistent standards, the more useful they will be to shareholders and other stakeholders. This development would be to the benefit of investors seeking relevant and meaningful information. Currently, as the TCFD report notes, "[E]vidence suggests that the lack of consistent information hinders investors and others from considering climate-related issues in their asset valuation and allocation processes." As ESG disclosures become more standardized and more easily comparable across companies and industries, investors should have a greater ability to decide for themselves whether, and to what extent, to factor the information into their investment and voting decisions. Moreover, if BlackRock is transparent about when and how it will use its voting power, investors also will be able to factor in the disclosure requirements and voting decisions of BlackRock when they make their decisions as to how to invest their funds and vote their shares.

Fiduciary Responsibility

In his letter to CEOs, Mr. Fink emphasizes the fiduciary responsibilities of both investment managers and boards of directors:

> As an asset manager, BlackRock invests on behalf of others, and I am writing to you as an advisor and fiduciary to these clients. The money we manage is not our own. It belongs to people in dozens of countries trying to finance long-term goals like retirement. And we have a deep responsibility to these institutions and individuals—who are shareholders in your company and thousands of others—to promote long-term value.

It remains to be seen whether, under the aegis of stewardship, institutional investors and public companies can work together in a productive and meaningful partnership to address today's headline issues—such as sustainability and climate change—in the pursuit of long-term value.

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