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CORPORATE GOVERNANCE

Analysis

SEC Regulation of ESG Disclosures

While the SEC traditionally has required disclosure of financially material information, its new leaders are clearly considering requiring reporting of ESG-related information whether or not it is financially material. In this edition of their Corporate Governance column, David A. Katz and Laura A. McIntosh explore the current disclosure framework and the challenges and questions to come.

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David A. Katz and Laura McIntosh. Courtesy photos

The U.S. Securities and Exchange Commission has indicated that ESG disclosure regulation will be a central focus of recently confirmed SEC Chair Gary Gensler's tenure. At the top of the agenda is climate change disclosure, and the Commission is taking steps toward broader reform. Then-Acting Chair Allison Herren Lee **announced** in March that the SEC will be "working toward a comprehensive ESG disclosure framework" and pursuing initiatives such as "offering guidance on human capital disclosure to encourage the reporting of specific metrics like workforce diversity, and considering more specific guidance or rule making on board diversity." Acting Chair Lee also **appointed** Satyam Khanna as senior policy advisor for climate and ESG to oversee and coordinate the SEC's efforts: "Having a dedicated advisor on these issues will allow us to look broadly at how they intersect with our regulatory framework across our offices and divisions." And earlier this month, Bloomberg **reported** that John Coates, the SEC's Acting Director of the Division of Corporation Finance, indicated that new disclosure requirements would focus on three areas: diversity, equity and inclusion; climate change; and human capital management.

The SEC appears to view its invitation for public input on climate change disclosure, which remains open until the middle of June, as the beginning of a potentially significant reconfiguration of corporate reporting on ESG matters in the near future.

While the SEC traditionally has required disclosure of financially material information, its new leaders are clearly considering requiring reporting of ESG-related information whether or not it is financially material. In Acting Chair Lee's **statement** requesting public input, she did not use the terms "financial" or "material" as qualifiers in describing the objective of possible new climate change disclosure requirements: "to provide more consistent, comparable, and reliable information for investors." This notable omission has led observers to speculate as to the SEC's goal in overhauling ESG disclosure, which has raised important questions: Should the SEC use ESG reporting requirements to drive societal or environmental reform or, more narrowly, to help investors create value in a rapidly evolving landscape of ESG risks and opportunities? Should the SEC maintain its traditional focus on requiring issuer reporting of financially material information, and, if not, should there be safe harbors for any financially immaterial information that ultimately may be required? As a trusted independent regulator, the SEC has the opportunity to encourage robust investor and issuer engagement on the future of ESG regulation, whether or not it proceeds with broad ESG disclosure reform. It may well be that the answers to the challenging ESG policy questions facing corporate America can best be achieved through the legislative process, with the SEC playing a prominent role in the national debate.

Proceeding With Caution

As we noted in an earlier **article**, there is a key distinction to be drawn between "important" information and "material" information. The SEC disclosure framework was designed to require reporting of information that is financially material to investors, not information that may be important at a societal level. Prof. Ann Lipton of Tulane University has **observed** that, in the United States, "corporate transparency is a function of the needs of the investing class. … Even if the public demands information about firms' environmental impact, their treatment of workers, their political activity, and their use of customer data, corporations are under no obligation to provide it absent a showing of relevance to an investor audience." Investors and the financial markets are the traditional audiences for SEC-mandated disclosure; the challenge for the Commission is how to facilitate access for the average investor to reliable, issuer-specific, financially material information that is generated in a cost-efficient way and provided in a useful format. Broad requirements for ESG reporting could be viewed as an attempt to shoehorn disclosures that may be relevant to society and stakeholders, but are financially immaterial to investors, into a system that was historically built for that narrower focus. It is unclear how much ESG-related information is financially material in the conventional sense, meaning that broad ESG disclosure requirements risk being seen as policymaking rather than content-neutral regulation. This carries significant risks both for the SEC and for market participants.

The SEC has a longstanding reputation as a fair and neutral regulator. This is fundamental to the successful execution of its tripartite **mission**—to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation—and key to the legitimacy of its actions. Procedurally, it stays close to its mandate by acting incrementally through the rulemaking process. Incremental rulemaking using the notice-and-comment process is doubly efficient from a procedural standpoint: first, it can be done relatively quickly, and second, it is a well-accepted regulatory path and thus less likely to generate controversy or legal challenge. Substantively, the mission of the SEC is viewed as politically neutral. Yet, as Prof. Virginia Harper Ho has **observed**, “disclosure is widely recognized as a soft form of regulation, incentivizing changes in corporate behavior where direct regulation may be difficult to achieve or enforce.” As an institution, the SEC should consider whether it would be prudent to resist the pressure from some quarters, albeit well-intentioned, to approach large-scale public policy projects with the specialized tool of securities law reporting requirements and instead move incrementally to expand requirements for financially material ESG disclosure in a substantively neutral context.

Reshaping the existing framework of financial materiality to include non-financially material ESG disclosure would entail a significant regulatory shift. Vanderbilt law and business professor Amanda M. Rose observed in her **SEC response submission**: “Requesting that the SEC adopt a framework for companies to use to disclose information on a broad set of topics, without establishing that any one of those topics is in fact financially material, is an unusual foray into SEC rulemaking.” Similarly, Commissioner Elad Roisman recently **observed** that “[some] proponents of this agency’s intervention sometimes offer rationales for action that are entirely outside the realm of securities law. A letter recently arrived at my office advocating for mandatory ESG disclosures and ended by saying: ‘There is no Planet B.’” The question, for now, is whether policy goals that may be considered important to society are beyond the SEC’s current mandate absent legislative action, or whether such initiatives would be a natural progression consistent with recent developments in the prevailing view of corporate purpose. Whether they wish to preserve or expand it, both traditionalists and progressives agree that the existing disclosure framework was designed for a specific purpose and in its current form is ill-suited to the informational needs of stakeholders and society at large.

Within the scope of its mandate, the SEC has a responsibility to be deliberate and transparent in its ESG rulemaking to minimize the costs of regulatory risk. As outlined in SASB’s recent SEC **comment letter**: “Climate risk … can be broken down into three broad categories: physical (e.g., extreme weather), transition (e.g., technological and market shifts), and regulatory (e.g., government imposition of carbon price or other regulation).” If the SEC intends to require broad ESG disclosure, it should be candid about its goals and provide a solid basis for any rulemaking initiatives, so that it does not exacerbate regulatory risk.

While public companies tend to adjust their behavior when forced to disclose information, they also adjust to those adjustments, potentially resulting in a range of downstream effects that are less likely in a regime of voluntary disclosure. If ESG disclosure is mandated for the purpose of driving changes in corporate behavior, then it may be likened to other types of regulation, such as taxes, that affect corporate behavior and require democratic legitimization. As a society, it is important to ask whether the SEC's reporting framework would be an effective or appropriate venue for shaping corporate policy and driving corporate activity, whether the repurposing of that framework would be a legitimate exercise of regulatory authority, and finally, whether all of these questions are more appropriately resolved through public discourse than by regulatory fiat.

SEC efforts to drive corporate policy also could implicate fundamental corporate law and governance issues. As Professor Rose **has observed**, "ESG topics veer far deeper into matters of traditional business judgment than the SEC has ever waded before." She argues that intervention on such matters potentially raises questions of federalism and runs the risk of undermining charter competition. Professor Rose **points out** that the European Union has taken a legislative approach to its far-reaching climate change regulation and disclosure: "The ESG disclosure mandates that have been imposed on listed companies in the EU since 2018 are explicitly tied to the EU's substantive policy embrace of the United Nation's Sustainable Development Goals. Moreover, they were promulgated pursuant to a call by the European Parliament to create disclosure requirements that 'take account of the multidimensional nature of corporate social responsibility (CSR) and the diversity of the CSR policies implemented by businesses matched by a sufficient level of comparability to meet the needs of investors and other stakeholders as well as the need to provide consumers with easy access to information on the impact of businesses on society.'" In her view, "[t]he SEC would be acting, by contrast, without predicate acts by political bodies endorsing the substantive ends sought." In the current era of partisanship, SEC actions to adopt broad new requirements for policy purposes without a solid foundation of authority are likely to be swiftly challenged.

The Complexity of ESG Disclosures

Leaving aside the difficult questions that would arise from new reporting requirements for non-financially material ESG information, the SEC still faces a challenging task in creating new regulations for the disclosure of financially material ESG information. In March, Corporation Finance Director Coates **acknowledged** the challenges: "Part of the difficulty is in the fact that ESG is at the same time very broad, touching every company in some manner, but also quite specific in that the ESG issues companies face can vary significantly based on their industry, geographic location and other factors. As such, there is no one set of metrics that properly covers all ESG issues for all companies. Moreover, the landscape is changing rapidly so issues that yesterday were only peripheral today are taking on greater importance." Given the diversity of corporate America, it is highly unlikely for any particular ESG issue to be material, or even relevant, to all companies. This point is a matter of

concern to issuers, as reflected in the **comment letter** submitted by Uber Technologies: "[W]e encourage the Commission to consider requiring that companies perform a company-specific materiality assessment to identify the ESG issues most relevant to their businesses. We believe that the most useful ESG disclosures will be grounded in the specific issues that are relevant to the particular company, as opposed to generic ESG disclosures that may or may not apply in a company's individual circumstances."

Any new required ESG reporting should include both qualitative standards and quantitative metrics. Metrics can become a de facto minimum without larger principles, while principles can yield little useful information without metrics. In key areas, both types of disclosures matter, as it is important for an investor to understand an issuer's principles and also have the ability to measure the results. Existing disclosure requirements for executive compensation are an example of a topic on which the SEC asks issuers to discuss philosophy as well as disclose numbers. It may be helpful for the SEC to begin by requiring principles-based disclosure while companies develop the internal workstreams necessary to generate and audit the data underlying ESG metrics. New ESG disclosure requirements will present a heavier burden for small-cap and mid-cap companies that may lack adequate resources to effectively address these issues.

The SEC could establish a temporary non-enforcement period during which companies can work on data collection, internal processes, and controls. Raising the quality of ESG disclosures to the point where they can be filed or furnished will be a daunting task for many issuers, and it may take years for companies to integrate and combine systems in order to generate certain types of data. It also would be important for any requirements to be scaled for company size. Furthermore, good faith estimates, assumptions and predictions should be protected in order to maximize the decision-useful information provided to investors. Carefully designed safe harbors are likely to encourage issuers to provide more meaningful disclosures and to foster dialogue between issuers and investors to improve reporting. If the SEC ultimately does require reporting of ESG information that is not financially material, there should be no liability for issuers beyond SEC enforcement or federal prosecution of intentional fraud. ESG disclosures should not be deemed "material" under the federal securities laws even if required, and there should be no private right of action regarding such disclosures. Permitting such lawsuits likely would generate widespread event-driven securities litigation. Instead, any investor complaints regarding these disclosures should arise from, and be limited by, traditional materiality principles.

It is likely, too, that the SEC will consider whether private companies should also be required to make ESG disclosure requirements. While the SEC no doubt wishes to avoid driving more public companies to go private in reaction to ESG rulemaking, the implications of such an approach must be carefully considered.

The Importance of Public Debate

In her SEC climate change submission, Professor Rose **observes** that "[t]he questions raised [in SEC-mandated ESG disclosure] include some of the most contested in the field of corporate and securities law, such as the value of interjurisdictional competition for corporate charters, the right way to conceptualize the purpose of the corporation, the proper allocation of managerial power as between the board and shareholders, and the social desirability of fraud-on-the-market class actions."

If consequential new policy is to be made, or the mandate of the SEC expanded, there should be public debate regarding the need for predicate legislative action such as was taken in the European Union. Some U.S. legislators have recognized that political action may be necessary to effect major change, and there is already proposed legislation. The **ESG Disclosure Simplification Act of 2021**, introduced in the House in February, would require annual proxy statements to include "a clear description of the views of the issuer about the link between ESG metrics and the long-term business strategy of the issuer; and a description of any process the issuer uses to determine the impact of ESG metrics on the long-term business strategy of the issuer." The draft legislation would direct the SEC to require issuers "to disclose environmental, social, and governance metrics" in any filing that requires audited financial statements. The SEC would further be charged with defining "ESG metrics" and specifically authorized to "incorporate any internationally recognized, independent, multi-stakeholder environmental, social, and governance disclosure standards" in that definition if it sees fit to do so. Potential liability for ESG disclosures would be significant under the draft bill: "It is the sense of Congress that ESG metrics, as such term is defined by the Commission … are de facto material for purposes of disclosures under the Securities Exchange Act of 1934 and the Securities Act of 1933." As it is clearly incorrect that ESG metrics—no matter how they are ultimately defined—would "de facto" be material to all issuers under the federal securities laws, this last provision seems intended to create a vast new category of private rights of action. While portions of this draft bill are problematic, it illustrates the significance of some of the actions currently contemplated by the SEC and further suggests that the legislative process may be the proper forum for the large questions in this area to be considered and resolved.

The importance of debate on issues of such consequence should be a point of general agreement. Commissioner Roisman recently **observed**:

> I have heard from some, who feel inclined to question the propriety of SEC regulation in this area, that they fear the reputational risk of being painted as "anti-climate," "anti-social justice," or other shades of immoral if they express their critiques publicly. … It is entirely reasonable for a person to feel that climate change deserves immediate attention from lawmakers *and still question* whether the SEC mandating new disclosures from U.S. public companies is an

> appropriate step for the agency. In this forum, I feel confident that we all recognize the fundamental questions here are about the SEC's authority as a regulator and whether this agency's intervention is appropriate to address the problems people have identified *in our markets*. This is an entirely healthy and necessary conversation, and it will be critical for us to have the full spectrum of market participants engaged. If the only people who feel safe to comment are those who want the agency to join the fight against climate change and those whose business models would benefit from new regulation, we will miss hearing from those voices who can alert us to the hidden costs and unintended consequences of our actions.

There is unprecedented interest in ESG at the current moment. It is time for substantive public consideration of the best path forward for ESG regulation in the American economy, including but not limited to the proper scope of reporting requirements. Matters such as human capital management, diversity, and climate change are important to society and deserve full consideration and resolution through a process of democratic accountability. While the SEC can and should take incremental action to improve issuer disclosure of material ESG information, and while it has the capacity to be a leader in facilitating public engagement on these important topics, as an institution it would be well-served by preserving its credibility as a nonpartisan regulator. The policy decisions that must be made in the coming years regarding ESG and corporate America are of paramount importance and implicate fundamental issues of law and governance. While no outcome will satisfy all participants, it is essential that the decision-making process be viewed as legitimate by both the regulators and the regulated.

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