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CORPORATE GOVERNANCE

Analysis

The SEC Takes Aim at the Public-Private Disclosure Gap

The SEC appears likely to embark upon a rulemaking process that would require ESG—or, more accurately, EESG (Employee, Environmental, Social and Governance)—disclosures from large private companies.

By David A. Katz and Laura A. McIntosh | January 26, 2022 at 12:45 PM

David A. Katz and Laura McIntosh. Courtesy photos

The U.S. Securities and Exchange Commission recently indicated its intention to narrow the disclosure gap between publicly-listed and privately-held companies. While the effort is in its formative stages, the SEC appears likely to embark upon a rulemaking process that would require ESG—or, more accurately, EESG (Employee, Environmental, Social and Governance)—disclosures from large private companies. In the European Union, a disclosure framework that began by requiring climate disclosures from public companies has rapidly expanded into proposals for robust EESG disclosures from private companies, regardless of their size. The SEC's initiative is likely to meet with a mixed reaction from the U.S. investor community, as some market participants view proposals to mandate EESG disclosure for large private companies as misguided and, more worrying, as the beginning of a slippery slope.

Regulatory action in this area is gaining momentum worldwide. It may well be the case that factors including political pressure, a worldwide focus on environmental and climate issues, and the blurring of the traditional line between the general public and the investing community make such regulation all but inevitable. And to be fair, the largest private companies—some with

valuations in the tens of billions of dollars—undeniably have a significant public impact. Yet it is also fair for U.S. market participants to question whether the SEC is the legitimate proponent of such regulation, and, further, to debate the scope and extent of what would constitute reasonable and tailored disclosure requirements for private companies. From the standpoint of institutional legitimacy and the public interest, a regulatory overhaul of the U.S. EESG disclosure framework would be best accomplished through Congressional action to establish a mandate for interagency coordination and implementation. In the absence of legislative action, regulatory overreach in this area by the SEC or a federal agency could jeopardize future efforts to regulate EESG disclosures for public and private companies alike. For now, while mandated private company disclosures may be on its wish list, it would be prudent for the SEC to take a measured approach and invite robust stakeholder participation to maximize the legitimacy and benefit of any regulatory action that is ultimately taken.

Expanding Disclosure Requirements on Two Dimensions

SEC Commissioner Allison Herren Lee has been very clear about her vision for increased EESG disclosure regulation for private as well as listed companies. In March 2021, in her capacity as Acting SEC Chair, she requested public comment on new climate disclosure requirements for public companies and at the same time previewed two further issues, asking, "[H]ow should we address the significant gap with respect to disclosure presented by the increasingly consequential private markets?" and stating, "[W]e should also consider the broader array of ESG disclosure issues…. That means working toward a comprehensive ESG disclosure framework." In other words, she views public company climate disclosures as a starting point, intended to expand in two dimensions: to include private companies and to include EESG topics beyond climate change.

The SEC is joined by some in the investor community in seeking expanded environmental disclosures. In his widely-read 2022 letter to CEOs, BlackRock's Larry Fink called for "governments to provide clear pathways and a consistent taxonomy for sustainability policy, regulation, and disclosure across markets" and requested that BlackRock's portfolio companies issue reports consistent with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). Several of the largest private equity firms, including Blackstone and KKR, are already embracing EESG for their portfolio companies and provide on their own websites some measures of EESG disclosures. While there is a public-relations element to these presentations, they also suggest a substantive commitment to EESG. Non-profit organizations, too, are pushing for increased environmental disclosure, often in partnership with investment funds. CDP, a non-profit global disclosure platform, recently announced a collaboration with private market investors holding $2.3 trillion in assets to request standardized environmental disclosure from over 1,000 firms.

Indeed, there is a growing global regulatory consensus that the largest companies should be subject to disclosure requirements, even if they are privately held. Justifications for subjecting large private companies to reporting requirements of the type that historically have been primarily imposed on public companies include the impact and influence of large private companies; the need to avoid incentivizing large companies to become or remain privately held; and the public interest in ensuring that large parts of the American economy are not opaque to policymakers, investors, and the public. In an October 2021 speech, Commissioner Lee

expressed her concerns over a lack of regulatory visibility into the largest private companies, noting that the so-called "unicorn" firms valued at or above $1 billion "have a dramatic and lasting impact on our economy…. But investors, policymakers, and the public know relatively little about them compared to their public counterparts." The number of unicorns has grown quickly in recent years, now numbering nearly 1000 by some estimates.

The United Kingdom, which has made a commitment to require EESG reporting across the UK economy, has already taken steps in the direction that the SEC is contemplating. As of April 2022, the UK will require large businesses to disclose climate-related financial information in line with TCFD recommendations. This requirement will apply to public and private companies with over 500 employees and 500 million pounds sterling in annual revenue and is expected to affect over 1,300 companies. The EU is taking an even broader approach with its proposed Corporate Sustainability Reporting Directive. This regulation is likely to come into effect in 2024 and would require all large companies, whether private or public, and all small- and medium-sized publicly-listed companies to report on EESG factors.

Yet, while the push for expanded regulatory requirements is gaining momentum, dissenting voices have spoken up at the SEC and elsewhere over the past year. SEC Commissioner Hester Peirce and then-SEC Commissioner Elad Roisman released a joint statement in December in which they criticized the SEC's regulatory agenda as impeding capital formation and aiming to "redo recently completed rules, add new regulatory obligations, and constrain investor choice." Some venture capitalists, institutional investors, and lawmakers have also expressed reservations about the expanded regulation of private companies. In particular, the possibility that the SEC may begin to look through holding entities to count individual shareholders of private companies, thereby bringing an unknown number of private companies into the regulatory regime, is raising concerns among investors and dissenting regulators.

Public input regarding the nature and scope of proposed rules is an essential part of the U.S. regulatory process. It is incumbent upon the SEC to invite a full and robust conversation about the expansion of disclosure requirements to private companies. Meaningful stakeholder participation is essential if the SEC is to maximize the benefit and the legitimacy of its rulemaking initiatives, particularly those that, as in this case, represent both a departure from past precedent and (as suggested by Commissioner Lee) a foundation for further expansion of regulatory oversight.

Maximizing Legitimacy and Utility

There is certain to be vigorous debate regarding the authority of the SEC to impose expanded EESG reporting requirements on private companies. In the absence of Congressional action to provide the SEC with a mandate to require EESG disclosures for broad public purposes, the SEC is limited in its statutory authority to the protection of investors. It is also limited in its expertise. The SEC could gain much on both fronts from collaboration with federal agencies that already have experience in EESG-related regulation. One possible path forward has been elaborated by former Delaware jurist Leo E. Strine Jr. in a recent proposal that would require "socially important" companies, whether public or private, with over $1 billion in annual sales to provide standardized disclosure regarding their businesses' impact on EESG. The plan, titled "Toward Fair and Sustainable Capitalism," would require these large public and private firms to annually

report on their impact on employee, environmental, social, and governance matters, including climate change. He proposes that the SEC develop rules, in consultation with the Departments of Labor, Commerce, and Justice, as well as the Environmental Protection Agency, to standardize corporate disclosures in order to maximize their usefulness to a wide audience, including a range of stakeholders as well as regulators. Mr. Strine observes that there is little value in requiring EESG disclosures if vast portions of the U.S. markets are exempt from the requirements, yet his proposal acknowledges that the SEC as it stands today possesses limited authority and expertise. Federal agency collaboration (preferably under the aegis of Congressional action) would significantly enhance the legitimacy and utility of any regulation in this space.

Commissioner Lee rightly observed in her October remarks that it is the role and responsibility of the SEC "to continually reassess whether we have the right balance between public and private markets—one that supports both innovation and a well-informed, optimized allocation of capital." Both public and private capital markets play important roles in the U.S. financial system. The challenge for the SEC is that its mandate includes protecting investors and promoting market fairness, not using securities regulation to promote public welfare and social responsibility. Arguably, the line between "investors" and the "public" has blurred in recent decades, as a majority of the American public is now exposed to both public and private market risk through pension funds, education savings plans, and company retirement programs. This systemic shift increases the complexity of the regulatory task. Finding a balance that hews to the SEC's mandate, recognizes current market realities, and does not overreach or impose unjustifiable burdens on private companies will be challenging, and the SEC should engage meaningfully with a broad array of stakeholders on any proposed regulatory action.

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