June 8, 2021

SEC Update: Commissioner Lee Speaks on Materiality

Late last month, SEC Commissioner Allison Herren Lee gave a keynote address at the 2021 ESG Disclosure Priorities Event (sponsored by several independent accounting and standard-setting organizations) in which she discussed four "myths" regarding materiality in SEC-required disclosure. Her speech laid further groundwork for potential action by the SEC to require ESG disclosure that is not qualified by materiality. Materiality and SEC regulation of ESG disclosures appear to be very high on the list of SEC priorities.

In her remarks, Commissioner Lee challenged each of the following assertions:

- "ESG matters (indeed all matters) material to investors are already required to be disclosed under the securities laws."
- "Where there is a duty to disclose climate and ESG matters, we can rest assured that such disclosures are being made."
- "SEC disclosure requirements must be strictly limited to material information."
- "Climate and ESG are matters of social or 'political' concern, and not material to investment or voting decisions."

Commissioner Lee expressed a dim view of the ability of management, accountants, auditors, and lawyers to make judgments as to materiality that reflect the views of investors:

> [A] principles-based standard that broadly requires disclosure of "material" information presupposes that managers, including their lawyers, accountants, and auditors, will get the materiality determination right. In fact, they often do not. … Although dependent upon the views of the reasonable investor, materiality determinations are typically made in the first instance by management. In doing so, management may rely on a "gut" feeling, anecdotal interactions, and even their own experience as investors. We know that in making these determinations, management

> frequently sees things differently from investors. … Lawyers and auditors, like managers, are asked to apply the "reasonable investor" test without necessarily having sufficient understanding of what investors want or expect. But there's more to it than that. Both lawyers and auditors have built-in incentives to agree with management, particularly on close cases. They have an economic and psychological incentive to want to retain positive relations with management. This can create a form of implicit bias or predisposition, causing auditors and lawyers to often expend efforts to support, rather than independently analyze, management's decisions. … Thus lawyers, auditors, and managers can and do get the determination of materiality wrong.

Commissioner Lee also asserted the SEC's authority to act broadly in the public interest:

> [O]ur statutory rulemaking authority under Section 7 of the Securities Act of 1933 gives the SEC full rulemaking authority to require disclosures in the public interest and for the protection of investors. That statutory authority is not qualified by "materiality." Similarly, the provisions for periodic reporting in Sections 12, 13 and 15 of the Securities Exchange Act of 1934 are not qualified by "materiality." … The concept of materiality arises under anti-fraud rules such as Rules 10b-5 and 14a-9, where it plays a role in limiting how much information must be provided. In other words, materiality places limits on anti-fraud liability; it is not a legal limitation on disclosure rulemaking by the SEC.

The SEC requested public input on climate change disclosure in March; the window for submissions will close this month. As it is unusual for the SEC to seek public comment in the absence of a proposed rule, report, or other framework for evaluation, it remains unclear how the SEC intends to proceed. Commissioner Lee's speech is yet another signal that the SEC views climate and ESG matters as proper subjects for rulemaking and strongly suggests that the prevailing view on the Commission is that it has the authority and the mandate to take broad action to require specific ESG disclosures, even if they do not meet the SEC's historical "materiality threshold."

David A. Katz
Laura A. McIntosh