

C O M M E N T

MAKING MANDATORY SUSTAINABILITY DISCLOSURE A REALITY

by Rick A. Fleming and Alexandra M. Ledbetter

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As we have come to expect from Prof. Jill Fisch, her recent article entitled *Making Sustainability Disclosure Sustainable*¹ introduces a novel and thoughtful policy proposal on a matter of critical importance to investors. In short, she suggests a new sustainability discussion and analysis (SD&A) section within the corporate annual report. In their SD&A, companies would be required to identify and explain the three sustainability issues most significant to their operations.² She describes her proposal as a “modest starting point” and “first step” for sustainability disclosure.³

The appeal of Professor Fisch's SD&A proposal is that it could get more companies to speak to ESG topics in a way that is meaningful to investors while accommodating the prerogative of boards of directors and executives to manage the business as they see fit. It also allows for a plurality of views on the significance of sustainability topics. Having companies identify and explain the three sustainability issues most significant to their operations is consistent with an important objective of the Commission's disclosure framework, as well as the Commission's Disclosure Effectiveness Initiative, which is to allow investors to see the company through the eyes of management.⁴ Under

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1. See Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L.J. 923 (2019) [hereinafter Fisch].
2. *Id.* at 929, 956-58.
3. *Id.* at 959.
4. See William Hinman, Director, Division of Corporation Finance, SEC, Applying a Principles-Based Approach to Disclosure Complex, Uncertain and Evolving Risks, Remarks at the 18th Annual Institute on Securities Regulation in Europe (Mar. 15, 2019), <https://www.sec.gov/news/speech/hinman-applying-principles-based-approach-disclosure-031519> (describing

this proposal, if a company did not address a topic in its SD&A, it might be reasonable to infer that the topic was not front-of-mind for the company's management.⁵

That said, a limitation of the SD&A proposal is that it might not get a company to speak directly to a particular issue that is the most significant to investors as opposed to management. An SD&A disclosure requirement could also be difficult to enforce because, as a practical matter, the SEC might be disinclined to challenge a company's subjective determination as to the most significant issues if that determination were facially plausible.

We agree that Professor Fisch's proposal represents a reasonable middle ground between those who favor mandatory disclosure of environmental, social, and governance (ESG) information and those who remain skeptical about whether such information is decision-useful for investors. Unfortunately, however, investor demand for ESG information has become such a polarized political issue that a middle-ground solution strikes us as unlikely to gain traction. In this environment, a “half-loaf” compromise is no more likely to be embraced than a “full-loaf” solution that investors may prefer. In other words, if we ever reach a point at which the Commission becomes willing to adopt an SD&A disclosure requirement, by then the Commission may be willing to go further and mandate ESG disclosures that are more fulsome, reliable, and comparable.

In general, we favor policy solutions that are pragmatic and reflect consensus among various stakeholders, such as the one offered by Professor Fisch. Sweeping changes can bring unintended consequences, and a wildly swinging

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- the utility of flexible, principles-based disclosure requirements for addressing informational needs that may be rapidly evolving).
 5. See Larry Fink, BlackRock Dear CEO Letter 2020, *A Fundamental Reshaping of Finance*, <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter> [hereinafter BlackRock Dear CEO Letter] (“In the absence of robust disclosures, investors, including BlackRock, will increasingly conclude that companies are not adequately managing risk.”).

policy pendulum creates a difficult environment for market participants of all stripes. However, in our view, investors should anticipate and begin to prepare for the possibility that U.S. policymakers in the future pivot to a whole-hearted embrace of ESG disclosure. Most importantly, investors need to continue coalescing around a preferred set of private-sector standards they would like the Commission to recognize and incorporate into ESG reporting requirements. Adoption and implementation of prescriptive ESG-related disclosure requirements is extremely challenging when there is so much variation among the private-sector frameworks because the SEC may be reluctant to choose one model over the others in the absence of a clear consensus surrounding any particular framework. Without a critical mass of support for a particular model, it may require an act of the U.S. Congress to determine which standards should become the official metrics for ESG disclosure in the United States.

I. Materiality of ESG Information

In the year that has passed since the publication of Professor Fisch's article, the case for ESG disclosure has become only stronger. We have seen more institutional investors and asset managers stressing the importance of comparable and decision-useful ESG disclosure by their portfolio companies. BlackRock, the world's largest asset manager, with assets under management of \$7.4 trillion as of December 31, 2019,⁶ announced recently that it would be asking the companies that it invests in on behalf of its clients to (1) publish disclosure in line with industry-specific Sustainability Accounting Standards Board (SASB) guidelines, or disclose a similar set of data in a way that is relevant to the particular business, and (2) disclose climate-related risks in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).⁷ State Street, with assets under management of \$3.1 trillion as of December 31, 2019,⁸ announced the launch of a system for evaluating the performance of a company's business operations and governance vis-à-vis what State Street had identified as financially material and sector-specific ESG issues, based on the SASB materiality framework and data from third-party providers.⁹ State Street explained that it uses this system to help clients understand their portfolio exposures, as well as inform its own investment and voting decisions.¹⁰

To be sure, some investors disfavor asset managers who utilize ESG information to make investment and voting decisions. They may be skeptical of putative correlations between sustainability practices and economic perfor-

mance, or they may simply disagree with the prioritization of values that, in their view, distort the proper role of a corporation. However, it seems apparent that BlackRock and State Street are as emphatic as they are because of client demand.¹¹ We agree with Professor Fisch that the demand for disclosure of ESG information can no longer be dismissed as the political agenda of special-interest groups and peripheral to the proverbial reasonable investor who is concerned about long-term value creation.¹² The statements of BlackRock, State Street, and numerous other investment advisers and asset managers demonstrate that for a critical mass of investors, ESG considerations can alter the total mix of information available for investment and voting decisions.

II. Moving Forward in the Current Environment

Although the Commission has expressed openness to some elements of ESG disclosure,¹³ it has not yet embraced anything approaching the scope of what Professor Fisch suggests. More broadly, there has been an apparent backlash from certain sectors against adherents of ESG investing who are perceived to have gained a toehold in matters of corporate governance. We note, for example, the characterization of shared views on ESG matters as "groupthink" and the draconian specter of an antitrust enforcement action against asset managers merely for voting the same way.¹⁴ Within the SEC's jurisdictional sphere, some have suggested that advisers may be violating their fiduciary duties by putting their own sociopolitical views ahead of the financial interests of their clients on ESG matters,¹⁵

11. See, e.g., BlackRock Dear CEO Letter, *supra* note 5:

Indeed, climate change is almost invariably the top issue that clients around the world raise with BlackRock. From Europe to Australia, South America to China, Florida to Oregon, investors are asking how they should modify their portfolios. They are seeking to understand both the physical risks associated with climate change as well as the ways that climate policy will impact prices, costs, and demand across the entire economy.

12. See Fisch, *supra* note 1, at 931-32.

13. In August 2019, the Commission voted to propose rule amendments to modernize the description of business, legal proceedings, and risk factor disclosures that registrants are required to make pursuant to Regulation S-K. The proposed amendment of Item 101(c) of Regulation S-K would require registrants to include in the description of business "[a] description of the registrant's human capital resources, including in such description any human capital measures or objectives that management focuses on in managing the business (such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the attraction, development, and retention of personnel)." Registrants need only provide this information "to the extent such information is material to an understanding of the business taken as a whole." See Modernization of Regulation S-K Items 101, 103, and 105, Securities Act Release No. 10668, 84 Fed. Reg. 44358, 44388 (Aug. 23, 2019).

14. See Editorial Board, *The BlackRock Backlash*, WALL ST. J. ONLINE (Feb. 27, 2020), <https://www.wsj.com/articles/the-blackrock-backlash-11582849130>.

15. See Editorial Board, *Larry Fink's Latest Sermon*, WALL ST. J. ONLINE (Jan. 17, 2020), <https://www.wsj.com/articles/larry-fink-latest-sermon-11579305418> (referring to BlackRock's attention to ESG disclosures by its portfolio companies: "We can't help but wonder if Mr. Fink, after a profitable life in business, is auditioning to be Treasury Secretary in, say, the Warren Presidency."); see also Christopher A. Iacovella, Chief Executive Officer, American Securities Association, Comment on Amendments to Exemptions From the Proxy Rules for Proxy Voting Advice and Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8

6. BLACKROCK, INC., 2019 Q4 EARNINGS RELEASE, <https://ir.blackrock.com/financials/quarterly-results/default.aspx>.

7. See BlackRock Dear CEO Letter, *supra* note 5.

8. STATE STREET CORPORATION, 4Q19 EARNINGS PRESENTATION, <http://investors.statestreet.com/>.

9. See Cyrus Taraporevala, President and CEO of State Street Global Advisors, *CEO's Letter on Our 2020 Proxy Voting Agenda*, <https://www.ssga.com/us/en/individual/etfs/insights/informing-better-decisions-with-esg> [hereinafter SSGA Dear Board Member Letter].

10. See *id.*

despite the lack of evidence such as SEC enforcement cases arising from examinations specifically focused on this question. We note that some commenters on the Commission's recent proxy voting rulemaking proposals¹⁶—both in favor of and opposed to the proposals—seem to view those proposals as an effort by the Commission to quash the expression of ESG-related concerns that go against the interests of management, although the Commission itself expressed no such intent in the rulemakings.¹⁷

Perhaps most damagingly, adherents of ESG investing suffer from the perception that their areas of interest are continually shifting and that existing reporting frameworks, metrics, and scoring methodologies are ill-conceived.¹⁸ Even among adherents of ESG investing, while there is general agreement that the “G” factors in ESG tend to be material, and that “E” is gaining momentum, there seems to be less consensus about the materiality of the “S” factors. Encouragingly, we have seen movement toward refinement and harmonization. A task force sponsored by the International Business Council of the World

Economic Forum released a consultation draft proposing a baseline set of universally applicable ESG metrics and recommended disclosure topics for all companies, across sectors and geographies, to report on in primary corporate reports to investors (such as annual reports and proxy statements).¹⁹ The task force sought to consolidate, to the extent possible, themes from existing reporting frameworks and standards in order to catalyze faster progress toward standardization.²⁰ The professional stature of the task force's participants²¹ is likely to make that particular initiative influential and reflects a building momentum for consensus, even though the ultimate product of that consensus remains an important open question. We note also the work of the Corporate Reporting Dialogue, an initiative convened by the International Integrated Reporting Council in which participants have sought to align existing reporting frameworks and standards in areas of overlap.²² In our opinion, these initiatives represent a viable path forward.

(Feb. 3, 2020), SEC File Nos. S7-22-19 and S7-23-19, at 2, <https://www.sec.gov/comments/s7-22-19/s72219.htm> [hereinafter American Securities Association Comment]:

Regrettably, in recent years federal securities laws have been co-opted by activists and CEOs of large asset managers who believe pushing political agendas with other people's money will endear them to politicians and potential clients in the public pension system.... [Most Americans] have absolutely no interest in fighting political or social battles through their 401k or other savings plans where entrusted fiduciaries are supposed to act in their best interest to grow and preserve their nest egg.

16. See Amendments to Exemptions From the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 87457, 84 Fed. Reg. 66518 (Dec. 4, 2019); Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8, Exchange Act Release No. 87458, 84 Fed. Reg. 66458 (Dec. 4, 2019).
17. See, e.g., American Securities Association Comment, *supra* note 15 (supporting both proposals, which the commenter sees as reining in an elitist ESG agenda); Chris Netram, Vice President, Tax & Domestic Economic Policy, National Association of Manufacturers, Comment on Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8 (Feb. 3, 2020), File No. S7-23-19, at 2, <https://www.sec.gov/comments/s7-23-19/s72319.htm> (supporting the proposed amendments to Rule 14a-8, which the commenter sees as necessary because “the proxy process has in recent years been hijacked by activists that seek to force companies to act according to their own narrow interests”); Mindy S. Lubber, CEO and President, Ceres, Comment on Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8 (Feb. 3, 2020), File No. S7-23-19, at 7, <https://www.sec.gov/comments/s7-23-19/s72319.htm> (opposing the proposed amendments to Rule 14a-8, which the commenter sees as inhibiting private ordering to address systemic and company-specific ESG risks).
18. See, e.g., Allisia Finley, *Bloomberg Sells “Sustainability,” but Buyer Beware*, WALL ST. J. ONLINE (Mar. 2, 2020), <https://www.wsj.com/articles/bloomberg-sells-sustainability-but-buyer-beware-11583193439>.

19. See World Economic Forum, *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*, Consultation Draft 5, 11 (Jan. 2020), <https://www.weforum.org/whitepapers/toward-common-metrics-and-consistent-reporting-of-sustainable-value-creation>.

20. *Id.* at 10-11. Standardization is the end goal because investors want transparency and comparability and companies want to address investors' informational needs in a more efficient fashion.
21. The task force was chaired by Brian Moynihan, Chairman and CEO of Bank of America and Chairman of the IBC and included dedicated staff from each of the Big Four accounting firms—Deloitte, EY, KPMG and PwC. See *Id.* at 5.
22. *Better Alignment Project*, CORPORATE REPORTING DIALOGUE, <https://corporatereportingdialogue.com/better-alignment-project/> (last visited Mar. 8, 2020).