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July 9, 2020

ESG-Related Developments in the US

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July 9, 2020 TO: ICI Members
ESG Task Force SUBJECTS: Disclosure
ESG RE: ESG-Related Developments in the US

Summarized below are (i) SEC Chairman Clayton's statements on an ESG-related webinar;[1] (ii) SEC Commissioner Roisman's speech on ESG matters, which also included an update on the SEC's outstanding proxy rulemaking;[2] and (iii) a GAO report on public companies' disclosure of ESG factors and options to enhance the disclosure.[3]

I. Chairman Clayton's Statements

SEC Chairman Clayton recently participated in a FCLTGlobal-hosted webinar on long-term investing, sustainability, and the role of disclosures. Chairman Clayton said that in evaluating the need for ESG-related disclosure, an issuer should analyze each of "E" "S" and "G" separately. Disclosure of material information includes financial and nonfinancial information and should be evaluated from a reasonable investor's perspective. For example, disclosure regarding climate change is material to a reasonable investor in a property and casualty company. In contrast, a reasonable investor considering investing in a fabric manufacturer in the Midwest would consider the importance of climate change differently.

Clayton noted that the SEC staff is reviewing, and commenting on, public company disclosure related to environmental, or "E," issues and "at some point" SEC's 2010 guidance regarding disclosure related to climate change would be updated.[4] He noted that many ESG metrics are forward-looking and that we are moving into "somewhat uncharted territory" given the subjective and uncertain nature of any forward-looking information. He identified the issue as "how to use disclosure principles and metrics to get to a meaningful place." He stated that while it is difficult to get to the point where metrics are certain enough to be auditable, it is possible for management to make "good faith estimates" based on "understandable assumptions" and the estimates should be consistent with the way management thinks about the business.

Clayton noted that the SEC already requires disclosure around governance, or "G" and that disclosure makes it easy for investors to understand the governance structure of US public companies. He also referred to SEC guidance around disclosing diversity in the boardroom as relating to "S." Clayton then pointed out that US issuers have greater liability risk for material misstatements or omissions than issuers outside of the US.

Clayton underscored the SEC's commitment to international organizations (*e.g.,* FSB, IOSCO) and the importance of working with global regulators on ESG matters.

II. Commissioner Roisman Remarks

SEC Commissioner Roismandelivered a speech at the Society for Corporate Governance National Conference, which addressed briefly the status of the Commission's proxy rulemaking agenda and then set forth, for the first time, the Commissioner's views on ESG matters, particularly (i) calls for mandated ESG disclosure for public companies, and (ii) asset managers' ESG disclosure.

Public Company Disclosure. Roisman indicated that he has serious reservations about imposing prescriptive disclosure requirements on public companies, stating that "this type of mandated disclosure is often fraught with personal views, subjectivity and agendas that are often unrelated to "investor welfare."

He explained that

> the Commission's principles-based framework *requires* disclosure of all material information, but it *allows* each individual company to tailor that information so that it is useful to their investors. This benefits investors because it highlights for them what they need to know to make informed decisions. In addition, important information is not lost in a sea of inapplicable information. For the avoidance of doubt, ESG issues can be material to companies and necessitate disclosure.

Roisman also underscored the liability that US public companies face for the disclosure they provide in SEC filings and that they "face greater litigation risk than companies listed in almost every other jurisdiction… which seems like good incentive … to disclose material information, ESG or otherwise."

Asset Manager Disclosure. Roisman asserts that the SEC would be well within its authority to elicit more ESG disclosure from asset managers. He explained that more asset managers are urging public companies to enhance their disclosure and asserting that ESG metrics are driving their investment decisions. He states that he does not "ignore these calls for additional ESG information, but they raise questions in my mind about what the asset managers are doing with that information. How are they using it to improve returns for their investors? What analysis have they done to show it provides alpha?"

Roisman also stated that "retail investors who want "green" or "sustainable" products deserve more clarity and information about the choices they have" and he is concerned that

> the extent to which retail investors understand that some of these funds may be *prioritizing* environmental or social goals above the fund's economic returns … and that some of these funds invest and vote proxies primarily to achieve some environmental or social good, possibly *at the expense of* investment returns.

Roisman identified as another risk for investors "greenwashing," which he explained as asset managers conveying a false impression to retail investors that a given product is environmentally friendly. He also suggested that asset managers who want to use terms such as "ESG," "green," and "sustainable" in their fund names or to advertise their products be required to explain to investors the meaning of these terms.

> For example, how do these terms [ESG, green and sustainable] relate to a fund's objectives, constraints, strategies, and the characteristics of its holdings? Are "E," "S," and "G" weighted the same when selecting portfolio companies? Does the fund intend to subordinate the goal of achieving economic returns to non-pecuniary goals, and, if so, to what extent?

Roisman also referenced the recent SEC request for comment on fund names and indicated that he hopes that "the Commission can set forth clearer parameters around how investment products, such as "ESG" mutual funds and ETFs, are named."

III. GAO Report

Senator Mark Warner (D-VA) requested in 2018 that GAO review issues related to public companies' disclosures of ESG information. In response, GAO issued a report in July 2020, which examined, among other things,

- why investors seek ESG disclosures,
- public companies' disclosures of ESG factors, and
- the advantages and disadvantages of ESG disclosure policy options.[5]

Most institutional investors said that "ESG issues can have a substantial effect on a company's long-term financial performance" and they use ESG disclosures to better understand risks that could affect company financial performance over time, to monitor companies' management of ESG risks, inform their vote at shareholder meetings, or make stock purchasing decisions.[6]

Investors cited examples of companies using different methods and measures to disclose quantitative information, making the information difficult to compare across companies. Institutional investors also reported that they seek additional ESG disclosures to address gaps and inconsistencies in companies' narrative disclosures that limit their ability to understand companies' strategies for considering ESG risks and opportunities. But GAO also found that several ESG factors were commonly disclosed by companies across industries, including board accountability, climate change, and workforce diversity.

The Report indicated that the SEC staff generally uses a principles-based approach to oversee public companies' disclosures of nonfinancial information, including information on ESG topics. Under this approach, SEC staff rely primarily on companies to determine what information is material and requires disclosure in their SEC filings, such as 10-K filings. SEC officials noted while the federal securities laws generally do not specifically address the disclosure of ESG information, Regulation S-K's disclosure requirements for nonfinancial information apply to material ESG topics.

The Division of Corporation Finance distributed internal review guidance on a few ESG-related topics. This guidance illustrates how existing disclosure requirements may apply to a given topic and offers information for staff to consider when reviewing filings. In cases where the staff identifies a potential disclosure deficiency related to an ESG topic, they may issue a comment letter to the company to request additional information or additional disclosures. In April 2019, Corporation Finance reallocated responsibilities for reviewing nonfinancial information in 10-K filings, including ESG information, from attorneys to accountants.

According to most companies GAO interviewed, increasing comparability across companies may reduce investor demands on companies, which have been increasing for the last 5 years. One impediment to improved ESG disclosures that some institutional investors, companies, and market observers cited was the lack of consensus around what information companies should be disclosing. Investors articulated possible policy options to improve the quality and usefulness of ESG disclosures ranging from legislative or regulatory action requiring or encouraging disclosures, to private-sector approaches, such as using industry-developed frameworks. The Report notes that while new regulatory requirements could improve comparability across companies, voluntary approaches can provide flexibility to companies and limit potential costs.

The Report states that market observers recommended that SEC issue a new rule endorsing one or more comprehensive ESG reporting frameworks. However, there was not consensus on which framework companies should use. While some institutional investors supported the Sustainable Accounting Standards Board (SASB) or the Global Reporting Initiative (GRI) frameworks, investors also supported using other frameworks such as the Task Force on Climate-Related Financial Disclosures (TCFD), and Carbon Disclosure Project (CDP).

Some institutional investors and companies indicated that additional SEC interpretative releases addressing how ESG topics fit within existing disclosure requirements could be helpful. These releases could highlight the importance of ESG disclosures. Some investors and SEC review staff said that interpretive releases serve as a good reminder for companies to consider ESG issues in their disclosures. Interpretive releases also maintain flexibility for companies to disclose the information that is material for each company.[7] Other institutional investors, companies, and market observers instead recommended private-sector approaches to improve companies' ESG disclosures, reasoning that a voluntary approach would allow disclosure to vary by company and evolve over time.

The SEC generally concurred with GAO's findings and stated that the Report will contribute to the ongoing discussion around ESG disclosures among public companies, investors, and policy makers.

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endnotes

[1] *A Conversation with SEC Chairman Clayton: Long-term Investing, Sustainability, and the Role of Disclosures,* (23 June 2020), *available at* https://www.fcltglobal.org/resource/jay-clayton-sec-webinar/

[2] Commissioner Roisman*, Keynote Speech at the Society for Corporate Governance National Conference* (July 7, 2020), *available at* https://www.sec.gov/news/speech/roisman-keynote-society-corporate-governance-national-conference-2020

[3] *Public Companies: Disclosure of Environmental, Social and Governance Factors and Options to Enhance Them* (July 2020) (Report), *available at* https://www.gao.gov/assets/710/707949.pdf

[4] *SEC Guidance Regarding Disclosure Related to Climate Change* (2 February 2010), *available at* https://www.sec.gov/rules/interp/2010/33-9106.pdf

[5] GAO analyzed 32 large and mid-sized public companies' disclosures on 33 selected ESG topics. Among other criteria, GAO selected companies within eight industries that represented a range of sectors in the US economy and selected ESG factors that were frequently cited as important to investors by market observers. GAO also reviewed reports and studies on ESG policy proposals and interviewed 14 large and mid-sized institutional investors (seven private-sector asset management firms and seven public pension funds), 18 public companies, 13 market observers (such as ESG standard-setting organizations, academics, and other groups), and international government, stock exchange, and industry association representatives.

[6] Report at pages 9-11.

[7] SEC staff reviewed samples of disclosures on climate change and found that most sampled companies included climate-related information in their 10-K filings with varying levels of detail. As a result, SEC staff decided against recommending that the Commission issue additional releases.