MEMO# 33548

May 25, 2021

SEC Commissioner Allison Herren Lee Speech on Materiality

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TO: ICI Members
ESG Advisory Group
ESG Task Force
SEC Rules Committee SUBJECTS: Disclosure
ESG RE: SEC Commissioner Allison Herren Lee Speech on Materiality

In a May 24 speech, SEC Commissioner Allison Herren Lee provided her views on the myths and misconceptions about materiality, which are summarized below.[1]

Myth #1: ESG matters (indeed all matters) material to investors are already required to be disclosed under the securities laws.

Commissioner Lee stated that they frequently hear that new climate or ESG disclosure requirements are unnecessary because the existing disclosure regime already requires the disclosure of all material information. She stated that this is simply not true and reflects a fundamental misunderstanding of the securities laws. Public company disclosure is not automatically triggered by the occurrence or existence of a material fact. Rather, disclosure is only required when a specific duty to disclose exists, she said.

She stated that a duty to disclose may arise by virtue of an explicit SEC disclosure requirement, such as those set forth in Regulation S-K, or in order to make other statements made by a company materially accurate or not misleading.

She observed that the securities laws currently include little in the way of explicit climate or other sustainability disclosure requirements. In many instances, therefore, disclosure may be required only when a particular discussion of climate is collateral to something else disclosed by the company. The same is true for many ESG matters that lack express disclosure requirements. Thus, she said, climate and ESG information important to a reasonable investor is not necessarily required to be disclosed simply because it is material.

Myth #2: Where there is a duty to disclose climate and ESG matters, we can rest assured that such disclosures are being made.

Commissioner Lee stated that investors are essentially told that if something is material, it is already being disclosed, suggesting that such disclosure is both required and effective. Even when a duty to disclose exists, however, 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, she said.

A disclosure system that lacks sufficient specificity and relies too heavily on a broad-based concept of materiality will fall short of eliciting information material to reasonable investors, she said.

Myth #3: SEC disclosure requirements must be strictly limited to material information.

The SEC's statutory rulemaking authority under Section 7 of the Securities Act of 1933 gives it full rulemaking authority to require disclosures in the public interest and for the protection of investors and is not qualified by "materiality," she said. Similarly, the provisions for periodic reporting in Sections 12, 13 and 15 of the Securities Exchange Act of 1934 are not qualified by "materiality."

She noted that 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.

She observed that in practice Regulation S-K has, from the outset, required periodic reports to include information that is important to investors but may or may not be material in every respect to every company making the disclosure. Examples include disclosures of related party transactions, environmental proceedings, share repurchases, and executive compensation.

The idea that the SEC must establish the materiality of each specific piece of information required to be disclosed in its rules is legally incorrect, historically unsupported, and inconsistent with the needs of modern investors, especially when it comes to climate and ESG, she said.

Myth #4: Climate and ESG are matters of social or "political" concern, and not material to investment or voting decisions.

She asserted that the idea that investor concerns with scientifically supported risks like those associated with climate change is grounded in "politics" turns fact-based analysis on its head. In addition, she said, the fact that a topic may have political or social significance does not foreclose its being material, either qualitatively or quantitatively. Finally, investors, the arbiters of materiality, have been overwhelmingly clear in their views that climate risk and other ESG matters are material to their investment and voting decisions, she said.

In conclusion, Commissioner Lee stated that "[w]e must not be diverted by mistaken views regarding the SEC's rulemaking authority" and she hopes "we can dispense with these misnomers as we continue the important debate on how best to craft a rule proposal on climate and ESG risks and opportunities."

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endnotes

[1] SEC Commissioner Allison Herren Lee, Living in a Material World: Myths and Misconceptions about "Materiality" (May 24, 2021), available at https://www.sec.gov/news/speech/lee-living-material-world-052421.