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## The U.S. Regulatory Framework for ESG Disclosures

### Key Takeaways

- *The Securities and Exchange Commission (the “SEC”) takes a principles-based, materiality-focused approach to disclosure that applies equally to ESG disclosures.*
- *While an increasing number of groups have called on the SEC to be more prescriptive on ESG disclosures, and notwithstanding the prospect of more prescriptive disclosure in Europe, a shift to standards that track, for example, the recommendations of the Task Force on Climate-related Financial Disclosures (“TCFD”) is unlikely in the short term.*
- *The absence of more prescriptive SEC disclosure requirements should not be interpreted to mean that lawsuits or enforcement actions are not being, and will not in the future be, brought in connection with ESG disclosures or failure to address ESG matters.*

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### Overview

This client alert, part of a series that reviews developments in the environmental, social and governance regulatory landscape, provides an introduction to the current ESG regulatory disclosure framework in the United States. While the SEC has not mandated disclosure of ESG considerations in periodic reports, it has issued guidance related to climate change and other ESG-related disclosure over the past decade.

### ESG Disclosure Guidance

The SEC’s general disclosure guidance emphasizes materiality — the extent to which a reasonable investor would consider information important in relation to an investment decision. Historically, disclosure requirements in the United States largely have been rules-based, but recently the SEC has shifted to a more “principles-based” approach. Members of the Division of Corporation Finance staff have expressed the view that principles-based disclosure requirements offer flexibility that “should result in disclosure that keeps pace with emerging issues, like ... sustainability matters, without the need ... for the [SEC] to continuously add to or update the underlying disclosure rules as new issues arise.”<sup>1</sup>

**Environmental Matters.** The SEC issued guidance in 2010 that addressed how existing disclosure requirements could apply to climate-related issues. In reminding SEC reporting companies of the importance of regularly evaluating their disclosure obligations in respect of these issues,<sup>2</sup> the SEC emphasized long-standing materiality standards, calling on companies to consider the materiality of factors such as the direct and indirect impacts of legislative and regulatory changes on operating and financial decisions, capital expenditures to reduce greenhouse gas emissions and the physical risks of climate change.

The guidance called attention to the potential effect of such factors on specific areas of disclosure: descriptions of the business; disclosure of litigation; risk factors and management's discussion and analysis of financial condition and results of operations ("MD&A"). The MD&A is where companies address financial performance as seen through the eyes of management and where they are to provide information on the potential variability of their earnings and cash flows. This latter element is founded on the requirement that companies must identify known trends, events, demands and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance.

In 2016, the SEC issued a concept release on business and financial disclosures, which touched on sustainability themes.<sup>3</sup> The SEC noted that Congress had mandated disclosure addressing specific policy concerns, such as conflict minerals, payments by resource extraction issuers to foreign governments and health and safety violations at mining-related facilities. The SEC also noted that there were calls for greater disclosure of public policy and sustainability matters, and asked for comment on both topics, including around line-item disclosure requirements. Even in 2016, the SEC was cognizant of the emergence of sustainability reporting frameworks and inquired, for example, which, if any, frameworks should be used for additional disclosure requirements should the SEC mandate some form of line item disclosures. The SEC has yet to act on the sustainability matters about which it requested comment (though according to an analysis of comment letters, two-thirds of the more than 276 non-form comment letters received by the SEC addressed sustainability-related concerns and over 80% of those letters called for improved sustainability information in SEC filings, with only 10% opposing SEC action).<sup>4</sup>

**Social issues.** Board diversity is not mandated for public companies under either SEC rules or stock exchange listing standards, and like other ESG topics, the regulatory angle is rooted in disclosure. In 2009, the SEC required companies to disclose whether and, if so, how, a nominating committee considers diversity in identifying board nominees. If the board has such a policy, companies must also disclose how the policy is implemented and how the board or the nominating committee assesses the effectiveness of the policy. In 2019, the SEC issued two Compliance & Disclosure Interpretations (116.11 & 133.13) clarifying what disclosure of "self-identified diversity characteristics" of directors and director nominees is required.

Recent developments suggest that the SEC may be ready to make incremental changes with respect to social disclosures. In 2019, the SEC proposed changes to Item 101 of Regulation S-K that would add "human capital" as one of the topics to be disclosed, to the extent material, in SEC reporting company business narratives.<sup>5</sup> The existing rule only requires companies to disclose the number of their employees.<sup>6</sup> The 2019 proposals have not been finalized.

**Governance matters.** In 2009, when the SEC adopted the disclosure rules on diversity, it also adopted disclosure rules covering various other governance matters. Then-Chair Mary Schapiro noted that "[b]y adopting these rules, we will improve the disclosure around risk, compensation, and corporate governance, thereby increasing accountability [for officers and directors] and directly benefiting investors."<sup>7</sup> The 2009 rule changes covered the relationship of compensation policies and practices to risk management; the

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background and qualifications of directors and nominees; legal actions involving a company's executive officers, directors and nominees; board leadership structure and the board's role in risk oversight; stock and option awards to company executives and directors; and potential conflicts of interests of compensation consultants.

Finally, though beyond the scope of this client alert, it is worth noting that some states are embracing disclosure beyond what is required by the SEC. Several states, for example, have passed legislation requiring disclosure on board diversity. Investor groups have also sought public disclosure of company reports required by the Equal Employment Opportunity Commission regarding employment data related to race/ethnicity, gender and job category.

### **Developments in 2020**

The principal critique of the SEC's ESG approach from the investor community has been that it gives little guidance as to what impacts should be addressed, and how. This criticism is raised against a backdrop of increasing prescriptive disclosure frameworks elsewhere, especially Europe and from non-governmental organizations. Federal legislators have responded with various proposals, including with respect to climate change disclosure,<sup>8</sup> although such legislation is unlikely to pass in the current term of Congress.

In January, the SEC proposed amendments to modernize its MD&A disclosure requirements. The proposals did not address climate change, but SEC Chairman Clayton and two other SEC Commissioners each addressed climate change-related disclosures in separate statements. The Chairman reaffirmed that the SEC's approach would remain disclosure-based and rooted in materiality, though he noted that his views on regulation of ESG disclosures may change as a result of various factors, such as the actions of other policymakers and market participants, or the availability of new information.<sup>9</sup> The Chairman cited the following as informing his current views:

- For companies and investors, capital allocation decisions based on, or materially influenced by, climate-related factors tend to be forward-looking and likely involve estimates and assumptions regarding complex and uncertain matters that are both company- and industry-specific, as well as regional, national and multinational, in nature.
- The SEC's disclosure-based regime is founded largely on disclosure of currently verifiable and largely historical company-specific information. Forward-looking disclosure requirements are limited and, in many cases where forward-looking information is required or provided voluntarily, the information is afforded safe-harbor protection.<sup>10</sup>
- When crafting and implementing disclosure mandates and guidance, regulators should not be substituting their operational and capital allocation judgments for those of companies and investors.

- The US regulatory regime differs from other regimes from an investor protection perspective, as well as a public and private liability and enforcement perspective. In effect, “facially analogous disclosure mandates should not be expected to equate to uniform effects across jurisdictions.”

Commissioner Hester Peirce urged caution so as not to overburden the concept of materiality.<sup>11</sup> In contrast, Commissioner Allison Herren Lee noted that the MD&A proposal “was notable for what it does not do: make any attempt to address investors’ need for standardized disclosure on climate change risk.” She suggested that principles-based materiality standards had not produced disclosure that was consistent, reliable and comparable, and urged a more robust effort, suggesting that the SEC should lead on climate-related disclosures, failing which the SEC risks “falling behind international efforts and putting U.S. companies at a competitive disadvantage globally.”<sup>12</sup>

In May, the Investor-as-Owner Subcommittee of the SEC’s Investor Advisory Committee recommended that the SEC establish disclosure policies on ESG topics.<sup>13</sup> Noting that the “use of ESG-related disclosures has gone from a fringe concept to a mainstream, global investment and geopolitical priority,” the Subcommittee recommended that the SEC update reporting requirements to “include material, decision-useful, ESG factors,” though it did not endorse a particular ESG standard.

The Subcommittee’s view is not widely shared. One Commissioner responded that a new SEC disclosure framework for ESG “seems an unnecessary response” as the existing disclosure framework is sufficient.<sup>14</sup> Thereafter, Chairman Clayton warned that any analysis that combines separate ESG metrics across a range of companies into a single ESG rating or score would be “significantly over-inclusive and imprecise.”<sup>15</sup> Then, Commissioner Elad Roisman suggested that since ESG covers a broad range of issues that tend to be subjective and constantly evolving, prescriptive disclosure rules would not be an improvement.<sup>16</sup>

### **Implications**

The global push for more detailed and uniform disclosure standards reflects two trends: a greater awareness of ESG issues (particularly tied to climate) and a desire for consistency as disclosure standards and guidelines proliferate. A future set of Commissioners, or Congress, could embrace more prescriptive standards, including, for example, by endorsing the TCFD recommendations. The calls for improved information on sustainability in SEC filings, for example, in response to the 2016 SEC comment release (cited by Commissioner Lee in her January Public Statement), remain unanswered.

In the meantime, companies must make difficult decisions about what to disclose and how much detail to provide. Companies may see a benefit to voluntary ESG disclosures and/or face pressure from stakeholders demanding such disclosures. There is a growing trend of addressing sustainability matters in separate sustainability reports.<sup>17</sup> Companies need to not only weigh the potential materiality of known trends and uncertainties for purposes of their MD&A disclosures,<sup>18</sup> they must also be alert to the fact that, while silence – absent a specific duty to disclose – is not misleading, once a company chooses to speak, it is in different

regulatory territory. Statements that are aspirational, with appropriate disclaimers, for example, will find greater protection. Securities fraud actions have been brought, and likely will become more prevalent, notwithstanding the SEC's current position on ESG disclosures or any future shift to line-item requirements.

We will focus in another alert on the recent rise in securities law and state law derivative actions based on ESG claims.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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- <sup>1</sup> William Hinman, "Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks," Remarks at the 18th Annual Institute on Securities Regulation in Europe (March 15, 2019), available [here](#).
- <sup>2</sup> See Securities and Exchange Commission, "Commission Guidance Regarding Disclosure Related to Climate Change" (February 2010), available [here](#).
- <sup>3</sup> See "Comment Release: Business and Financial Disclosure Required by Regulation S-K" (April 13, 2016), available [here](#).
- <sup>4</sup> See Sustainability Accounting Standards Board, "The State of Disclosure" (2016), available [here](#), cited in Commissioner Allison Herren Lee's Public Statement, *infra* note 12.
- <sup>5</sup> SEC Proposed Rule, "Modernization of Regulation S-K Items 101, 103, and 105," SEC Release Nos. 33-10668, 34-86614 (August 8, 2019), at 110, available [here](#).

- <sup>6</sup> The proposed rule would revise Item 101(c) to require 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).”
- <sup>7</sup> SEC, Press Release, “SEC Approves Enhanced Disclosure About Risk, Compensation and Corporate Governance,” (December 16, 2009), available [here](#).
- <sup>8</sup> Legislators introduced the Climate Risk Disclosure Act (H.R. 3623) in the House in July 2019. A Senate version (S. 2075) was also introduced in July.
- <sup>9</sup> See SEC Public Statement by Chairman Jay Clayton, “Proposed Amendments to Modernize and Enhance Financial Disclosures; Other Ongoing Disclosure Modernization Initiatives; Impact of the Coronavirus; Environmental and Climate-Related Disclosures” (January 30, 2020), available [here](#).
- <sup>10</sup> Interestingly, in the context of COVID-19 disclosures, in April, Chairman Clayton and Division of Corporation Finance Director Hinman requested reporting companies to provide as much forward-looking information as practical regarding future operations and financial planning. See “The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19” (April 8, 2020), available [here](#). The call was framed as a request because the suggested disclosure could be voluntary. MD&A requirements to address known material trends, events or uncertainties inherently have a future focus. However, the SEC has long recognized the distinction between prospective information that is required to be discussed in an MD&A and voluntary forward-looking disclosure. As noted in the two seminal MD&A releases, required disclosure and voluntary disclosure both involve some prediction or projection – “[t]he distinction between the two rests with the nature of the prediction required.” As in past pronouncements, Messrs. Clayton and Hinman encourage reporting companies “that respond to [their] call for forward-looking disclosure to avail themselves of the safe-harbors for such statements and also note that [they] would not expect good faith attempts to provide appropriately framed forward-looking information to be second guessed by the SEC.”
- <sup>11</sup> See SEC Public Statement by Commissioner Hester M. Peirce, “Statement on Proposed Amendments to Modernize and Enhance Financial Disclosures” (January 30, 2020), available [here](#).
- <sup>12</sup> See SEC Public Statement by Commissioner Allison Herren Lee, “‘Modernizing’ Regulation S-K: Ignoring the Elephant in the Room” (January 30, 2020), available [here](#). Commissioner Lee notes that investors are calling for more consistent, reliable and comparable disclosures of risks and opportunities related to sustainability matters and that the MD&A is “uniquely suited” to climate risk disclosures.
- <sup>13</sup> See Draft Recommendation from the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to ESG Disclosure (as of May 14, 2020), available [here](#).
- <sup>14</sup> Commissioner Hester Peirce, “Remarks at Meeting of the SEC Investor Advisory Committee,” available [here](#).
- <sup>15</sup> See Chairman Jay Clayton, “Remarks at Meeting of the Asset Management Advisory Committee” (May 27, 2020), available [here](#).
- <sup>16</sup> Commissioner Elad L. Roisman, “Keynote Speech at the Society for Corporate Governance National Conference” (July 7, 2020), available [here](#). Commissioner Roisman also called for more detailed disclosure from asset managers, particularly in respect of investment products labelled as “ESG,” “Green” or “Sustainable.”

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- <sup>17</sup> See Governance & Accountability Institute, Inc., “2020 S&P Flash Report” (90% of S&P 500 Index companies publish sustainability/responsibility reports in 2019, up from 20% in 2011, 53% in 2012, 75% in 2014 and 86% in 2018), available [here](#). The report also provides a breakdown of use of international frameworks by reporting companies, for example: 51% use the Global Reporting Initiative (GRI) Standards; 11% mention, and another 14% align with, the Sustainability Accounting Standards Board (SASB), 11% mention, and another 5% align with, TCFD; and 36% with specific UN Sustainable Development Goals (SDGs).
- <sup>18</sup> There remains a split in the circuits over the question of whether investors can bring a private action for securities fraud based on a company’s failure to disclose known trends and uncertainties under the MD&A requirements, even if the omission does not make an affirmative statement misleading.