CLIENT MEMORANDUM

SEC Studying Change of Regulation S-K to Require ESG Disclosures

November 7, 2016

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In April the United States ("U.S.") Securities and Exchange Commission ("SEC") issued a "Concept Release"[1] ("2016 Release") soliciting public input on modernizing the disclosure requirements in Regulation S-K. Prompted by calls from investors increasingly interested in the potential relevance of environmental, social, and governance ("ESG") (aka, sustainability) variables in assessing firm competitiveness and shareholder value, in the 2016 Release the SEC included a limited discussion about, and requested comments related to, ESG disclosures.[2] The ESG-related content of the 2016 Release alone elicited hundreds of comments from interested publicly traded companies ("industry") and private sector stakeholders. The tenor and scope of discussions at public meeting held in late July, coupled with the SEC's analysis of possible ESG disclosures within the 2016 Release, indicate the SEC is seriously considering adoption of reforms to spur greater ESG transparency. This briefing highlights significant issues that have emerged over the course of this review.

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1 Precursor to a proposed rule. U.S. SEC, Business and Financial Disclosure Required by Regulation S-K [hereinafter 2016 Release], 81 Fed. Reg. 23915; Release No. 33-10064; 34-77599; File No. S7-06-16 (Apr. 13, 2016).

2 While the 2016 Release includes requests for comment on multiple aspects of Regulation S-K, this briefing focuses solely on the ESG disclosure elements. *Id.* at 204-215.

Background

Companies have grown accustomed to disclosing information on environmental, health, and safety performance, whether in securities filings, annual environmental reports, or responses to questionnaires from third-party stakeholder groups. The current transparency push would expand such disclosure to encompass a broader range of ESG areas thought by some stakeholders to bear on shareholder value, and to standardize and harmonize the content of such disclosures so that the information is comparable across industries and sectors. Issues frequently bundled under the ESG umbrella are:

- Environmental: performance, compliance history, and liability exposure, (e.g., infractions, releases, safety incidents), the use of renewable and/or non-renewable energy, greenhouse gas emissions and/or intensity (aka, carbon footprint or issues related to climate change), and water use;

- Social: employee-related matters, such as gender equality and diversity, implementation of international labor standards, supply chain management, human rights, and engagement with local communities; and

- Governance: anticorruption and bribery issues, political contributions, and the composition and roles of boards of directors.

Most companies voluntarily publish ESG reports,[3] and foreign governments increasingly regulate ESG disclosures. In 2015, 81% of U.S. corporations on the S&P 500 Index reported on sustainability, up from merely 20% in 2011.[4] Despite a marked increase in investor pressure and voluntary ESG reporting in the U.S. and abroad, U.S. regulators have largely shied away from regulating such practices. By contrast, foreign regulators have been much more proactive and have implemented, or are in the process of implementing, mandatory ESG disclosures (e.g., European Union Council (Directive 2014/95/EU), and measures in Brazil, South Africa, and China). Some stakeholders contend that, absent mandatory requirements and guidelines to harmonize reporting, the efficacy of ESG disclosures in the U.S. will remain largely subjective, as most voluntary disclosures do not provide for comparison across companies or sectors.[5]

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3 *See* Carol Casazza, *Oversight of Corporate Sustainability Activities*, DIRECTOR'S HANDBOOK SERIES 2014: EXECUTIVE SUMMARY (National Association of Corporate Directors & Ernst & Young LLP), at 3; *see also Corporate Sustainability Reports Reach 86% of US Largest Companies* [hereinafter, *Corporate Reporting*], SUSTAINABLE BUSINESS, Dec. 9, 2013, available here.

4 Louis D. Coppola, *Flash Report: Eighty One Percent (81%) of the S&P 500 Index Companies Published Corporate Sustainability Reports in 2015*, GOVERNANCE & ACCOUNTABILITY INSTITUTE, March 15, 2016, available here.

5 KPMG ranked the "quality" of Corporate Social Responsibility reports for "demonstrating a superior understanding of the impact of social and environmental issues on their business, and reporting on their strategy, performance and interaction with stakeholders[,]" and out of a possible score of 100, the 250 largest global companies and the largest U.S. companies received scores of only 59 and 54, respectively, indicating significant room for improvement on sustainability reporting. *Corporate Reporting*, *supra* n.3.

The SEC's attention to ESG matters advanced with its 2010 Guidance on Climate Change ("2010 Guidance").[6] Later, the Dodd-Frank Act of 2010 §§1502, 1503, and 1504 required the SEC to adopt rules regulating conflict minerals, health and safety violations at mining-related facilities, and payments to governments for the commercial development of oil, natural gas, or minerals, respectively.[7] With the 2012 Jumpstart Our Business Startups ("JOBS") Act,[8] lawmakers directed the SEC to perform a comprehensive review of its disclosure requirements. The SEC's 2016 Release responds to the JOBS Act mandates, as well as to criticism targeting regulators' lack of enforcement and oversight following the 2010 Guidance. The 2016 Release also appears designed to respond to criticism levied by pro-transparency stakeholders regarding inconsistent and/or inadequate 10-K ESG disclosures. After the close of a three month public comment period, on July 22, 2016, SEC regulators met with stakeholders to discuss current practices and opportunities for improvement in connection with Regulation S-K modernization.

<u>Modernization of Regulation S-K: The ESG Debate</u>

At Section IV(F) of the 2016 Release, "Disclosure of Information Relating to Public Policy and Sustainability Matters," the SEC identified and solicited public comment on ESG eight topics relevant to a future rulemaking.[9] Specifically, the SEC is exploring "which, if any, sustainability and public policy disclosures are important to an understanding of a registrant's business and financial condition and whether there are other considerations that make these disclosures important to investment voting and investment decisions."[10]

Major stakeholders representing industry, finance and investor groups, nonprofit organizations, and nongovernmental organizations ("NGOs") weighed in on the SEC's ESG-related requests. Following a review of comment letters submitted to the SEC, the Sustainability Accounting Standards Board ("SASB") noted that "[o]f the 227 original letters, 66% discussed sustainability disclosures."[11] Perhaps not surprisingly, industry and investors struck varying positions,[12] with industry generally rejecting mandatory ESG disclosures under Regulation S-K. The SEC discussed arguments against such measures, including whether such disclosures would adversely impact industry or would exceed the SEC's role and

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6 U.S. SEC, Commission Guidance Regarding Disclosure Related to Climate Change, 75 Fed. Reg. 6290 (Feb. 8, 2010).

7 15 U.S.C 78m(p) & 15 U.S.C 78m(q); *see also* U.S. SEC, 2016 Release at 204, *supra* n.1.

8 JOBS Act, H.R. 3606, 112th Cong. (2012).

9 Request for Comment Nos. 216-223, 2016 Release at 213-215, *supra* n.1.

10 *Id.* at 205.

11 Jean Rogers, *Investors Ask SEC for Better Sustainability Disclosure* (Aug. 16, 2016), available here.

12 For a more in depth explanation of how investors and industry approach ESG issues differently, *see* PwC Governance Insights Center, *Investors, corporates, and ESG: bridging the gap*, ESG PULSE (Oct. 2016).

mission, as well as its own past decision to reject mandatory ESG disclosure requirements.[13] Industry commenters argued that: materiality of ESG issues is sufficiently addressed in the 2010 Guidance, rendering further regulation unnecessary; the SEC does not have the authority to require such disclosures; materiality in the context of fiduciary duty covers only financial interests, and not social or environmental; mandatory disclosures would unfairly burden reporting entities (in terms of time and costs to comply); and such obligations could require companies to disclose information that is advantageous to competitors with little substantive benefit to investors.[14]

Comments submitted by nonprofit organizations, NGOs, and a range of scientific and academic institutions favored ESG disclosure requirements under a modernized Regulation S-K. Comments from finance and investor groups reflected the varying interests and investment philosophies of their members, but were also generally supportive of such changes. In evaluating arguments in favor of mandatory ESG disclosures, the SEC acknowledged the increasing prominence of ESG considerations and investor interest over the past forty-one years, specifically, increased investor engagement on ESG matters and incorporation of ESG considerations into financial analyses, and how this shift may warrant changes to what is considered "material" information that should be disclosed.[15]

Entities supporting greater disclosure articulated the following points: ESG matters are both quantifiable and material, and as such fall well within the SEC's purview; current SEC rules are inadequate to address risks associated with certain ESG matters, such as climate change; ESG disclosures would aid investors in identifying companies that have values aligned with theirs, in investment decisions, and at shareholder voting meetings; ESG disclosures would help investors to fully assess a company's management, efficiency, attention to all material sources of risk and return, and ability to mitigate all such risks; streamlining and harmonizing ESG reporting is necessary for the development of consistent and comparable criteria useful to investors; and the benefit to investors from robust disclosure of all material issues, including ESG matters, outweighs associated costs to publicly traded companies.[16]

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[13] "[I]n the past… disclosure relating to environmental and other matters of social concern should not be required of all registrants unless appropriate to further a specific congressional mandate or unless, under the particular facts and circumstances, such matters are material. 2016 Release at 205 & 209-210, *supra* n.1 (cross-referencing the SEC's Environmental and Social Disclosure, Release No. 33-5627 (Oct. 14, 1975), 40 Fed. Reg. 51656 (Nov. 6, 1975)).

[14] See Letter from Brandan Williams, American Fuel & Petrochemical Manufacturers, to Brent Fields, SEC (July 21, 2016); letter from Christina Crooks, National Association of Manufacturers, to Brent Fields, SEC (July 21, 2016); letter from John Hayes, Business Roundtable, to Brent Fields, SEC (July 21, 2016).

[15] 2016 Release at 210-211, *supra* n.1.

[16] See Letter from Rakhi Kumar & Christopher McKnett, State Street Global Advisors, to the SEC (July 20, 2016); letter from Steven J. Schueth, First Affirmative Financial Network, to Brent Fields, SEC (July 17, 2016); letter from Ingrid Dyott, Neuberger Berman Investment Advisers LLC, to Brent Fields, SEC (undated 2016); letter from Mindy Lubber, CERES, to Mary Jo White, SEC (July 21, 2016); letter from the Center for International Environmental Law, et. al., to Brent Fields, SEC (July 21, 2016); and, letter from Anne Sheehan, CALSTRS, to Brent Fields, SEC (July 21, 2016).

Conclusion: Engage Now

It remains to be seen whether and how the SEC will come down on clarifying or augmenting ESG disclosures in connection with Regulation S-K modernization. But the prospect of some form of heightened obligation looms. Notably, the SEC's Investor Advisory Committee called for Regulation S-K to be amended to hold ESG issues to the same materiality standards as other business (and more conventionally quantitative) risks.[17] Companies already engaged in ESG reporting should closely monitor and inform the reform process, bringing to bear their unique perspectives on ESG issues relevant to their internal and external stakeholders. Companies that are not yet identifying, managing, and reporting on ESG matters may want to begin developing strategies to respond to this changing disclosure landscape sooner than later.

If you have any questions regarding this memorandum, please contact William Thomas (202-303-1210; wthomas@willkie.com), Annise Maguire (202-303-1162; amaguire@willkie.com) or the Willkie attorney with whom you regularly work.

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[17] "It is clear that a significant, and growing number, of investors utilize sustainability and other public policy disclosures to better understand a company's long-term risk profile. The Committee believes that environmental, social and governance issues should be subject to the same materiality standards as other sources of risk and return under the Commission's rules. Like other sources of business risk and return, environmental, social and governance issues can be material based on a quantitative measure such as the expenditures required or the effect on earnings. Such issues can be material when considered in the context of qualitative factors such as the effect on a company's reputation or the impact on the purchasing decisions of the issuer's customers. Likewise these matters can impact voting decisions by shareholders." Letter from SEC Investor Advisory Committee, to SEC Division of Corporation Finance (June 15, 2016).