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COMMENT

THE NEED FOR SEC RULES ON ESG RISK DISCLOSURE

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Sustainability disclosure is at an impasse. Today's environmental, social and governance (ESG) disclosure is not delivering the decision-useful information financial markets need, yet the U.S. Securities and Exchange Commission (SEC) so far has not taken steps to formalize sustainability disclosure.

Prof. Jill E. Fisch proposes an innovative and constructive approach to breaking this stalemate by implementing an SEC mandate that would require public companies to provide a sustainability disclosure and analysis section in their annual reports where they disclose the three sustainability issues most significant to their operations. In modeling the SD&A on existing Management's Discussion and Analysis segments in financial filings, Professor Fisch favors adopting the MD&A's principles-based approach, requiring SEC to issue guidance on identifying sustainability issues that are likely to be material to investors.

I. Framing the ESG Disclosure Issue

We strongly agree with Dr. Fisch that SEC needs to provide more information to issuers on improving ESG disclosure. Her proposal addresses the significant financial risks posed by sustainability issues. It has become increasingly clear to issuers, investors, and regulators that ESG issues, especially climate change and water scarcity, pose financial risks and impacts to businesses. A growing number of global financial regulators are coalescing around the notion that issues like climate change are so pervasive and far-reaching that they are in fact systemic risks—and pose threats to the very stability of our financial markets.[1]

Recognizing this risk, thousands of companies have adopted voluntary disclosure standards, including the Global Reporting Initiative and other valuable disclosure standards such as the Sustainability Accounting Standards Board's (SASB's) industry-specific metrics and the CDP's detailed annual questionnaires for climate change and other issues.

Yet, while the volume of disclosure has grown tremendously, the amount of decision-useful disclosure that is comparable, consistent, and robust remains limited, particularly to investors in financial filings. In an analysis of 637 SEC filings, SASB found that while 75% of registrants acknowledged the risks posed by climate change, more than 40% use boilerplate language, and only 17% use metrics.[2]

Over the years, investors have urged SEC to improve the quality of ESG disclosure. A decade ago, at the request of investors, SEC introduced interpretive guidance on climate risk disclosure to try to bridge the gap between investors' needs and company disclosures. The results were initially promising, with 56% of companies in the S&P 500 reporting climate risks in their SEC filings in 2010 compared to 45% in 2009. And in 2010 and 2011, SEC staff issued 49 comment letters to companies in cases where their disclosure was inadequate.[3]

However, the focus of SEC leadership on ensuring that issuers follow the guidance lessened over time. Today, SEC is doing very little to encourage companies to disclose material climate risks and opportunities. A search for SEC comment letters asking issuers to improve their climate-related disclosure in Commission filings, for instance, reveals only one such letter from January 2017 to the present, to the company FLEX LNG Ltd.[4]

Even as the effectiveness of the SEC guidance declined in recent years, support for robust climate risk disclosure has grown dramatically among companies, investors, and other capital market actors seeking to make smart decisions to keep their businesses and investments resilient in the face of these risks. In December 2019, 631 investors

1. *Addressing Climate as a Systemic Risk: A Call to Action for U.S. Financial Regulators*, Ceres (June 1, 2020), https://www.ceres.org/resources/reports/addressing-climate-systemic-risk.

2. *Supporting the Work of the TCFD*, SASB, https://www.sasb.org/blog/supporting-work-tcfd/ (last visited June 14, 2020).

3. *Cool Response: The SEC & Corporate Climate Change Reporting*, Ceres (Jan. 30, 2014), https://www.ceres.org/resources/reports/cool-response-sec-corporate-climate-change-reporting.

4. *Building a Sustainable and Competitive Economy: An Examination of Proposals to Improve Environmental, Social and Governance Disclosures* 11 (2019) (written testimony of Mindy S. Lubber, CEO & President, Ceres, U.S. House of Reps., Comm. on Fin. Servs.), https://www.ceres.org/sites/default/files/files/FINAL/MSL/WRITTEN/TESTIMONY/HFSC/July/10/2019.pdf.

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managing over $37 trillion signed the Global Investor Statement to Governments on Climate Change, calling on world governments to improve climate-related financial reporting.[5] In 2018, investors representing $5 trillion in assets and other stakeholders petitioned SEC to initiate rulemaking to develop a comprehensive framework for ESG disclosure.[6]

II. Pros and Cons of the Sustainability Discussion and Analysis Proposal

Because investors are still not receiving decision-useful information from most companies on climate risks, we agree with Professor Fisch's assumptions that material ESG disclosures belong in financial filings, and that SEC action on this issue would help remedy this. However, we see pros and cons in her proposal to require a sustainability discussion and analysis (SD&A) section in annual reports, in which companies follow a principles-based approach for identifying their three most significant sustainability issues.

A critical advantage of the SD&A proposal over the current SEC approach is that, if properly implemented by SEC, it would improve the quality and quantity of disclosure that companies provide. Currently, many companies provide more qualitative than quantitative ESG information in their SEC filings. If they explain how they determined an issue is significant, such as through a materiality matrix, they usually do so in voluntary disclosure. An SD&A disclosure of the potential impacts of ESG issues on economic performance, which explains why these issues are significant to a company, would result in better information for investors.

The SD&A's focus on the board of directors is also important. Under Professor Fisch's proposal, the board would be responsible for determining which sustainability issues the company must disclose and for certifying that disclosure. This aims to enhance the board's role in understanding and overseeing the company's sustainability practices. However, companies may need to add directors with ESG expertise, or train directors on ESG issues, to take up this responsibility in an informed manner. Based on our work with corporate boards, we have come to understand that many directors at U.S. companies do not see ESG as something that belongs on their agenda.

Despite these advantages, we believe that the SD&A proposal will not be sufficient to meet investors' needs for decision-useful information. The proposal leaves it to companies to identify and explain three sustainability issues most significant to their operations. That discounts the varying capabilities of companies, where some have extensive experience analyzing ESG risks but many do not. The proposal would also benefit from using standardized disclosure metrics, a growing trend in voluntary disclosure. That would reduce the opportunities for corporate greenwashing, in which companies choose those metrics that reflect their work in the best light.

The proposal also lacks industry-specific disclosure metrics, another important trend in voluntary disclosure. Because ESG risks manifest themselves differently in each industry, these types of metrics would greatly improve comparability. Finally, the SD&A approach would also silo sustainability issues in a new section in SEC filings. This undermines the argument that sustainability issues are no different from other material financial issues that must be disclosed as robustly as those other risks.

III. Ceres' Proposal

Ceres' position is that voluntary and mandatory disclosure systems are both invaluable, and that SEC should issue rules mandating ESG risk disclosure. Last year, Ceres' CEO Mindy Lubber testified in support of the Climate Risk Disclosure Act, which would require issuers to disclose physical and transition risks related to climate change.[7]

After 10 years' experience with the SEC's interpretive guidance on climate risk disclosure, Ceres and many of our investor partners now support SEC rulemaking, an approach that would provide comparable disclosure of ESG issues. Petitioners to SEC have called for SEC rules that "encompass a mix of required elements based on industry and sector; information about firms' governance of sustainability issues across industries; and principles based elements to act as a materiality backstop."[8] Given that ESG risks and ESG disclosure metrics continue to evolve, this approach to SEC rulemaking could balance mandatory metrics with principles-based elements, to allow for comparability as well as flexibility for instances in which metrics are evolving.

With regard to climate risks, Ceres' position is that SEC should consider (1) information that is needed from all companies to enable financial regulators to assess systemic climate risks; (2) industry-specific risks that, if properly disclosed, enable investors to compare companies within an industry, and (3) governance, risk management, and scenario planning information that demonstrate how well companies are situated for a clean energy transition.

To allow more flexibility to issuers, SEC could incorporate a comply or explain framework into parts of the rule. Where a company does not identify a metric as financially material to their circumstances, they would be required to provide their rationale for this decision. This would encourage more robust corporate analyses of ESG risks, given that many companies do not yet fully incorporate such risks into their risk management functions.

5. Nonie Reyes, *COP25: Global Investors Urge Countries to Meet Climate Action Goals*, UN News (Dec. 9, 2019), https://news.un.org/en/story/2019/12/1053081.
6. Cynthia A. Williams & Jill E. Fisch, Request for Rulemaking on Environmental, Social, & Governance (ESG) Disclosure (Oct. 1, 2018), https://www.sec.gov/rules/petitions/2018/petn4-730.pdf.
7. Written testimony of Lubber, *supra* note 4.
8. Williams & Fisch, *supra* note 6, at 13.

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IV. Conclusion

Professor Fisch does a great service in advancing the argument for incorporating SEC-mandated ESG disclosure in financial reporting and explaining why it is critical now more than ever. Based on our experience, we prefer an approach that treats disclosure of ESG risks the same as any other material financial risk. Using climate risk as a model for other ESG issues, we recommend that SEC consider industry-specific risks, governance, risk management, and scenario planning disclosure when beginning a rulemaking.