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Recent SEC Guidance and Trends in Stakeholder Expectations May Impact Reporting of ESG Metrics in Mainstream Filings

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OVERVIEW

The Securities and Exchange Commission ("SEC") recently issued guidance (hereinafter, the "SEC KPI Guidance", available here)[1] to registrants on disclosure of Key Performance Indicators ("KPIs") and other metrics in the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") section of periodic SEC reports filed pursuant to the Securities Exchange Act of 1934 (the "Exchange Act").[2] The SEC KPI Guidance, which became effective on February 25, 2020, is consistent with prior SEC staff statements to the effect that—even though no line item requirement of the SEC's disclosure rules mandates ESG[3] disclosure—general materiality standards require disclosure about ESG issues that are material to the financial condition or results of operations of a reporting company.[4] Thus, despite the fact that Item 303 of Regulation S-K focuses on financial disclosure, the SEC KPI Guidance reminds reporting companies that, in preparing MD&A, "companies should consider whether disclosure of all key variables and other factors that management uses to manage the business would be material to investors, and therefore required".[5]

Importantly, the SEC KPI Guidance outlines three disclosures that should accompany key performance metric disclosure in order to provide appropriate context for investors' understanding and evaluation:

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[1] SEC, Interpretive Release No. 33-10751, *Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations*, Jan. 30, 2020 (available at: https://www.federalregister.gov/documents/2020/02/25/2020-02296/commission-guidance-on-managements-discussion-and-analysis-of-financial-condition-and-results-of).

[2] Item 303 of Regulation S-K sets forth the disclosure requirements for MD&A and requires that a reporting company (1) disclose specific information about its financial condition, changes in its financial condition and its results of operations and (2) provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations.

[3] The subject of Environmental, Social and Governance ("ESG") encompasses a broad and varied set of topics, such as climate change; land and water use; waste management; biodiversity concerns; raw material sourcing; renewable energy initiatives; product safety; human capital management; labor relations; worker health and safety; human rights; supply chain standards; executive compensation; diversity matters; community relations; and business ethics issues.

[4] Both Regulation S-K and Regulation S-X include a catch-all provision mandating that, in addition to information expressly required in a filing, registrants also must include any material information necessary to ensure that statements are not misleading. *See* 17 CFR 230.408 and 17 CFR 240.12b-20; *see also* William Hinman, *Remarks at the 18th Annual Institute on Securities Regulation in Europe: Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risk*, Practicing Law Institute, Mar. 15, 2019 (available at https://www.sec.gov/news/speech/hinman-applying-principles-based-approach-disclosure-031519).

[5] SEC KPI Guidance at page 2.

- clear definitions for such qualitative and quantitative indicators, and descriptions of how they are calculated; (with respect to this point the KPI Guidance notes that changing definitions or methodologies in subsequent periods may raise concerns and likely will require incremental disclosure in future filings highlighting the change and "recasting" prior periods to conform to the new definition or methodology);
- disclosure as to the perceived usefulness of the information to investors; and
- disclosure regarding management's use of the metrics in managing or monitoring the business's performance.

Although not listed as a separate item of required disclosure, the SEC KPI Guidance essentially includes a fourth requirement by stating that a registrant should also consider whether there are estimates or assumptions underlying the metric or its calculation, and whether disclosure of such items is necessary for the metric not to be materially misleading.

While it has become commonplace for companies to voluntarily report ESG-related metrics in corporate sustainability, social responsibility or similar reports, as well as in other stand-alone documents in response to investor requests relating to various voluntary reporting frameworks, some companies also disclose—and the SEC KPI Guidance reminds us that, in some circumstances, companies may be required to disclose—such metrics in their Exchange Act filings. This presents unavoidable challenges for registrants, including determining whether ESG metrics or other indicators are material for disclosure purposes and whether the registrant is maintaining adequate controls and procedures to ensure the accurate calculation and disclosure of those items.

RECENT TRENDS AFFECTING ESG DISCLOSURE DECISIONS AND RISKS

While the reach of the SEC KPI Guidance may be limited on its face, it is reflective of the continued demand for ESG information by stakeholders more broadly and the increasing focus on ESG-specific disclosure and performance indicators by many asset managers and other investors in particular. Over the past several years, these demands have resulted in the development of scores of new disclosure, reporting and rating frameworks around ESG issues.[6] Methodologies can vary meaningfully, as can the ratings awarded to an individual company (including as a result of whether the information compiled and/or ratings generated under such frameworks involve company input or rely solely on public information). In addition, a company and its stakeholders and ratings organizations may not always be in full agreement regarding the most important ESG issues, or metrics, to describe the company's business or performance. As a result, identifying and assessing the most salient ESG-related business risks and opportunities, and where and how best to report them, raises challenges, particularly in the absence of industry-standard reporting regimes and metrics.

More recently, and not surprisingly, there has been greater commentator and stakeholder interest in advancing standardized reporting regimes. For example, in January 2020, the International Business Council of the World Economic Forum released a white paper entitled "Toward Common Metrics and Consistent Reporting of Sustainable Value Creation" in an attempt to address the challenges posed by the lack of consistency in how companies measure and report the "shared sustainable value they create".[7] At the same time significant asset managers continue to emphasize ESG concerns. For example, in their most recent annual letter to their clients, the chief executive officers of both Blackrock and State Street announced various initiatives placing climate change-related and other sustainability concerns at the center of their investment strategies to promote long-term value, including advocating for companies to make enhanced corporate disclosure to address stakeholder sustainability risks and adopt strategies to reduce ESG-related risks. In addition to encouraging companies to act, these asset managers are themselves acting, including, in the case of Blackrock by stating that its discretionary funds will disinvest by mid-2020 in companies that generate more than 25% of their revenues from thermal coal production and, in the case of State Street, taking voting action, beginning this proxy season, against board members at companies in certain indices that are rated as "laggards" under State Street's recently developed R-Factor scoring system.[8]

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[6] These include, for example, the Taskforce on Climate-Related Financial Disclosures, the Sustainability Accounting Standards Board, the Carbon Disclosure Project and the Global Reporting Initiative, as well as rating agency scoring protocols, such as those published by MSCI ESG Research, Bloomberg ESG Data Services, Institutional Shareholder Services and the DowJones Sustainability Index.

[7] World Economic Forum, *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*, Jan. 22, 2020 (available at http://www3.weforum.org/docs/WEF_IBC_ESG_Metrics_Discussion_Paper.pdf). The report proposes a common set of metrics, drawing from existing frameworks and standards where possible, across four "pillar" areas of disclosure to "reduce fragmentation and encourage faster progress toward a systematic solution". *Id*. at page 5 (preface by Bank of America Chairman and CEO Brian Moynihan).

[8] *See* Larry Fink, *Letter to CEOS: A Fundamental Reshaping of Finance*, BlackRock, Jan 14, 2020 (available at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter) and Cyrus Taraporevala, *CEO's Letter on our 2020 Proxy Voting Agenda*, State Street Global Advisors, Jan. 28, 2020 (available at https://www.ssga.com/us/en/individual/etfs/insights/informing-better-decisions-with-esg). In addition, since year end 2015, the total value of equity funds with official socially responsible and/or ESG mandates has increased greater than six-fold to over $500 billion. Chris Matthews, *ESG and Socially Responsible Equity Funds Add to Record*

Importantly, these kinds of developments reflect two dynamic trends, namely an increasing expectation that ESG objectives and performance are key factors in valuing a company's business over the long term, and the growing focus by asset managers and other investors on a broad spectrum of ESG criteria.[9] We expect this to continue, including additional support for more standardized reporting frameworks and metrics and increased pressure on companies to not only "talk the talk" on ESG matters but to demonstrate that they can "walk the walk" (for example, by setting and reporting on strategies and objectives across various ESG issues in comparable, and verifiable, ways).

While the main vehicles for ESG reporting to date have been sustainability reports and other voluntary reports, we expect that there will be an increasing push from some constituencies to provide more and more of such disclosures and related metrics in periodic Exchange Act filings with the SEC. Any such disclosures will thus become subject to the entire set of SEC reporting rules (and the corresponding liability regime), including the SEC KPI Guidance. Thus, it will be important for registrants to understand and track developments around ESG disclosure trends, look deeply at existing and new performance metrics that represent the "pulse" of their businesses as well as ESG-related risks, engage with stakeholders on such issues and, where appropriate, integrate those concerns into their management, governance, investor relations and reporting practices.

KEY DISCLOSURE PRINCIPLES AND PRACTICE CONSIDERATIONS

With this backdrop, we have set forth below certain key principles and considerations that may be relevant to the potential inclusion of expanded KPI and ESG-related metrics in periodic reports filed with the SEC, taking into consideration the recent SEC KPI Guidance.

- Even ESG metrics that are material are unlikely to be tied to a company's financial statements. In that case, the SEC's well-developed non-GAAP financial disclosure rules would not apply. However, the SEC KPI Guidance reminds that general disclosure principles related to non-GAAP disclosure should be considered in presenting a metric, as well as in assessing whether to include further information necessary to ensure that the presentation of the metric is not misleading in the circumstances under which it is presented.
- The disclosures recommended by the SEC KPI Guidance (see items (i) to (iii) under "Overview" above) apply to all metrics disclosed in the MD&A (whether or not material or disclosed voluntarily). Nonetheless, given the multiple overlapping forums in which ESG metrics may be disclosed in today's environment, as a matter of best practice, these guidelines should be considered in all ESG metric disclosures including earnings releases and other stakeholder communications to which SEC disclosure rules may not apply.
- SEC rules require all reporting companies to establish and maintain disclosure controls and procedures ("DCP")[10] and then evaluate the effectiveness of their DCP and disclose the results of that evaluation on a quarterly basis. As all periodic report disclosures are subject to DCP, the SEC KPI Guidance reminds companies to maintain effective DCP, and this is particularly crucial when presenting material KPIs and ESG metrics developed from the company's own information.[11] Notably, the reporting company's chief executive officer and chief financial officer are required to certify as to their responsibility for DCP as well as to the accuracy of the company's disclosure in its periodic report about the design and effectiveness of the company's DCP.[12] Thus, as a matter of practice, it is

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Inflows in December, MarketWatch, Dec. 6, 2019 (available at https://www.marketwatch.com/story/esg-and-socially-responsible-equity-funds-add-to-record-inflows-in-december-2019-12-06

[9] Notably, shareholder proposals seeking increased company disclosure and corporate responsibility around climate change and other environmental and human rights topics remain at significant levels and have met with increasing success over the past few years. For environmental and social shareholder proposals that went to vote, the median for the percentage of votes cast in favor rose from single digits between 2000 and 2008 to approximately 29% in 2019. As of March 2020, there were at least 429 ESG shareholder resolutions filed with the SEC, and over 300 of them were headed for votes. Approximately 460 ESG shareholder resolutions were filed in each of 2019 and 2018, with 41% (187 total) and 38% (177 total) going to a vote, and approximately 44% and 46% being withdrawn (which can often signify that an agreement has been reached), in those years, respectively. *See* As You Sow, Sustainable Investments Institute and Proxy Impact, *Proxy Preview 2020*, Mar. 18, 2020; As You Sow, Sustainable Investments Institute and Proxy Impact, *Proxy Preview 2019*, Mar. 12, 2019; Kosmas Papadopoulos, *The Long View: US Proxy Voting Trends on E&S Issues from 2000 to 2018*, ISS Analytics, Jan. 31, 2019 and Jon Hale and Jackie Cook, *Proxy Season Shows ESG Concerns on Shareholders' Minds*, Morningstar, Inc., Aug. 21, 2019.

[10] The SEC defines the term, "disclosure controls and procedures" as controls and other procedures designed to ensure that information required to be disclosed by the issuer in all the reports that it files under the Securities Exchange Act of 1934 is: (a) recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms, and (b) accumulated and communicated to the issuer's management, as appropriate to allow timely decisions regarding required disclosures. *See* 17 CFR § 240.13a-15(e).

[11] SEC KPI Guidance at page 4; see also 17 CFR § 240.13a-15.

[12] *Id*. at Footnote 11.

important for a reporting company to incorporate procedures underlying the development and disclosure of ESG metrics into its DCP framework.

- The SEC KPI Guidance also reminds companies that effective DCP also covers the collection of information potentially subject to disclosure or needed to assess the materiality of relevant risks.[13]
- It has become increasingly common for third-party ESG data providers to publish ratings of a company's ESG performance, based on a proprietary ranking system, and asset managers and other shareholders seem to value these reports. Companies that are the subject of the providers' research often work directly with the providers, offering information helpful to the preparation of more complete and accurate reports. If a company intends to rely on third-party expert reviews of its ESG performance, or to name those experts in SEC filings, the company may be required to obtain their consent. As this would expose the experts to potential liability under the securities laws, this may give rise to additional concerns.
- Public statements about ESG metrics may be subject to liability risk. Any public disclosures (whether in Exchange Act filings, sustainability reports or otherwise) that are materially inaccurate or misleading may be subject to SEC investigation and, ultimately, to enforcement actions and private securities lawsuits. While private securities actions alleging a material misstatement or omission in a company's periodic reports require a showing of several elements to establish a claim (such as reliance, scienter and loss causation) and some courts have found allegedly misleading ESG statements to be mere, non-actionable "puffery", there has been an uptick in these types of claims in the U.S., and we expect that trend to continue.[14] Moreover, as part of the effort to ensure that ESG-related disclosures are accurate and not misleading, given that disclosure around ESG performance and risks is often included in a variety of different reporting vehicles, companies should track and seek to achieve consistency across all such disclosures (including voluntary reports, reports by industry groups of which the company is a member, MD&A and other SEC-required disclosure, other shareholder communications and, if relevant, litigation positions).
- We find that stakeholders frequently inquire about, and rating organizations typically consider and assess, the role of a company's management and Board of Directors with respect to ESG issues, including ESG disclosure and the development and reporting of ESG metrics. Companies should consider the sufficiency of governance oversight, practices and competency at the management and Board levels. This includes considerations relating to how companies identify ESG risks; whether they are formalized in appropriate management systems; how and how often such issues are reported to, and taken up by, the Board; and whether and how management is engaged with investors on their concerns regarding near- and long-term ESG strategy, goals, costs and opportunities.
- The heightened importance of ESG matters—and, in particular, the growing attention by investors on the potential impact that ESG risks can have on a company's long term business value—also could, under certain circumstances, result in potential claims against directors alleging a failure to meet their oversight and monitoring obligations under *Caremark*[15] and related case law, which further underscores the value of board-level attention to a company's key ESG concerns.

Please feel free to contact us if we can provide further information on these or other ESG-related matters.

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[13] *Id*. at Footnote 12.

[14] For example, several major oil companies have been sued by state attorneys general in the U.S. alleging fraud in respect of environmental disclosure. Although some companies have successfully defended these cases, other cases continue.

[15] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996)