Making Sustainability Disclosure Sustainable

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Overview

- Corporate sustainability is a hot topic but
  - Widespread disagreement over what sustainability means
  - Proliferation of disclosures and metrics, with substantial variation
  - Additional concerns about voluntary disclosure
  - Inconsistent disclosure impedes assessing the relationship between sustainability and economic performance
- This article
  - Advocates mandatory sustainability disclosure incorporated into financial reporting and
  - Offers a first step disclosure mechanism – sustainability discussion and analysis (SD&A)
- The proposal focuses on a first step approach
  - Key advantages are flexibility, limited cost, integrated approach, and board oversight
  - The proposal does not address the relative merits of more expansive disclosure requirements

Why Should Sustainability Disclosure be Integrated into Financial Reporting?

- Sustainability affects economic value
  - Risk management
  - Strategic planning
  - Board oversight
  - Short-termism
- SEC-mandated financial reporting
  - Involves issuers, professionals and regulators with disclosure expertise
  - Encourages norm development and standardization
  - Increases accountability

The Proposal: Sustainability Discussion and Analysis

- Flexible narrative framework
- Modeled on existing MD&A (management discussion and analysis) and CD&A (compensation discussion and analysis)
- Principles-based approach
- Focus on issuer-specific sustainability issues

The Proposal: Sustainability Discussion and Analysis

"A disclosure duty exists where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation"

- Disclosure premised on known trends akin to MD&A supplemented by SEC guidance
- Director certification of the SD&A
- Enforceability

MD&A Guidance on Uncertainty

(1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

(2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required **unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur**.

CD&A Modifications

- List of principles-based topics for issuers to address
- Examples of material information
- Disclosure is to focus on the "most important factors"

The Role of SEC Guidance for SD&A

- The proposal contemplates that the SEC would identify general and industry-specific issues likely to require disclosure such as
  - Climate change
  - Cybersecurity
  - Human capital and supply chain
- SEC guidance can be supplemented by staff review and revised in accordance with disclosure practices

Implementing SD&A

- Director c
  - Place re … of directo
  - Designe … ow
  - Improv

Potential to moderate the liability standard through safe harbors, due diligence defense or other mechanisms – analogy to evolving director oversight duties under state law (Caremark)

- Enforcem
  - Proposal contemplates both public and private enforcement
  - Public enforcement is primary
    - SEC enforcement tools include informal comments, books and records violations as well as fraud-based litigation
    - SEC has the institutional competence to develop expertise
  - Private enforcement is a valuable supplement
    - No independent private right of action, but
    - Fraudulent SD&A disclosures are actionable as securities fraud
    - Scope of private litigation is likely to be limited

Conclusion

- Existing sustainability disclosure is fragmented, incomplete and unreliable
- Mandatory integrated disclosure would improve disclosure quality and facilitate an evaluation of the economic impact of sustainable business practices
- SD&A offers a practical tool for implementing a sustainability disclosure requirement into existing financial reporting