Sustainability Risk is Investment Risk

A Comment on *Making Sustainable Disclosures Sustainable*

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In her *Making Sustainability Disclosures Sustainable* article, Professor Jill E. Fisch proposes creating a Sustainability Discussion and Analysis ("SD&A") section to expressly obligate reporting companies to disclose their three most significant sustainability issues in annual reports to the U.S. Securities and Exchange Commission ("SEC"). Professor Fisch posits that the proposed SD&A, as a workable *first* step in mandating sustainability disclosures,[2] would provide comparability and reliability to reports that are currently difficult to compare and which may vary in reliability. Professor Fisch correctly recognizes the challenges of both reporting on sustainability issues from the issuer perspective, as well as using such disclosures from the investor perspective. But what if the that obligation to adequately disclose sustainability issues already exists within extant SEC reporting requirements?

This comment acknowledges the need for accuracy, reliability, and comparability in sustainability disclosures and agrees that piecemeal regulation of individual sustainability issues is inefficient and undesirable. We are unconvinced, however, that new mandatory disclosure requirements – even principle-based requirements – are necessary to achieve those goals. Under existing SEC regulations and guidance, issuers are already obligated to understand their sustainability risks, assess the materiality of those risks, and disclose material risks in their annual reports even if those risks are difficult to quantify. And as environmental, social, and governance ("ESG") issues continue to gain importance to investors, customers, employees and other stakeholders, all issuers will need to provide the ESG-informed disclosures or risk backlash from the investment community and potentially other stakeholders. Indeed, some investors are not only calling for ESG disclosures, but are also identifying the format for those disclosures.[3] One pathway to more accurate, reliable and comparable sustainability disclosures is for companies to ensure ESG issues are incorporated into Enterprise Risk Management ("ERM") processes. Doing so may help companies better assess issues that are often difficult to quantify, which may in turn clarify the materiality of these risks and opportunities and ultimately lead to better disclosures.

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[1] *Authors' note: The opinions stated herein are the personal opinions of the authors and do not represent official positions of Pfizer Inc.*

[2] This comment adopts the interchangeable use of sustainability with environment, social, and governance ("ESG") referenced by Professor Fisch. *See* Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 170 GEO. L.J. 923, 931 (2019).

[3] Larry Fink, Larry Fink's 2020 Letter to CEOs: A Fundamental Reshaping of Finance, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

The Existing Framework Covers Sustainability

Professor Fisch proposes that the primary obstacle to incorporating sustainability disclosures into annual reports is the discretionary component of materiality. As noted in the full article, the best articulation of the materiality standard is that of the Supreme Court of the United States, which states that: information is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote," and, in other words, if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[4] The Court also advised that while doubts about the materiality of the information would be common, given the prophylactic purpose of securities laws and that disclosure is controlled by management, "it is appropriate that these doubts be resolved in favor of those the statute is designed to protect," i.e., in favor of the investor.[5]

Since then, SEC has issued at least two guidance documents that outline how sustainability issues could – and should – fit into the existing disclosure framework, including the Management's Discussion & Analysis ("MD&A") on which the SD&A is modeled. The 2010 Commission Guidance Regarding Disclosure Related to Climate Change provides not only specific information about climate change disclosures, but provides a roadmap for how other sustainability issues could be assessed for materiality and where those disclosures might fit within the annual report.[6] The guidance notes that a distinctive characteristic of MD&A is that "the flexible nature of this requirement has resulted in disclosures that keep pace with the evolving nature of business trends without the need to continuously amend the text of the rule."[7] Moreover, the guidance reminds issuers that there is a process for assessing issues that are difficult to quantify: once a trend, demand, commitment, event or uncertainty is known, management must assess whether it is likely to come to fruition and "[i]f 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.

[4] *TSC Indus., Inc. v. Northway Inc.*, 426 U.S. 438, 449 (1976); *see also* Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 170 Geo. L.J. 923, 936 (2019).

[5] *TSC Indus., Inc.*, 426 U.S. at 448.

[6] *See* Commission Guidance Regarding Disclosure Related to Climate Change, Securities Act Release No. 9106, Exchange Act Release No. 61,469, 75 Fed. Reg. 6289, 6290 (Feb. 8, 2010) ["2010 Release"] ("This release outlines [SEC's] views with respect to [SEC's] existing disclosure requirements as they apply to climate change matters.").

[7] *Id.* at 6294. *See also* Thomson Reuters, Executive Perspective: The Evolution of SEC Regulation for Sustainability Disclosure (May 10, 2016) ("MD&A and related disclosures tend to change and evolve over time, based on investor interest, availability and usefulness of information, as well as access to relevant and meaningful disclosure or accounting standards, such as those developed by SASB. SASB standards are designed to help companies meet the changing information needs of today's reasonable investor."), https://blogs.thomsonreuters.com/sustainability/2016/05/10/executive-perspective-laying-the-groundwork-for-sec-regulation-on-sustainability/.

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."[8]

More recently, SEC issued its Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations to guide disclosure of key performance indicators and metrics in MD&A.[9] In this guidance, SEC highlighted that MD&A is used by some companies to disclose non-financial and financial metrics "when describing the performance or the status of their business" including environmental metrics, such as "metrics regarding observed effect of prior events on their operations."[10] In other words, while SEC did not specifically use "sustainability" or "ESG" in this guidance, it is additional guidance for companies to use MD&A to qualitatively discuss issues that are material to management and strategic planning of the business. This guidance also reminds companies that they are required to have effective controls and procedures to support the accuracy and consistency of the data.[11]

There has been a marked increase in the importance of ESG issues (climate change being chief among them) to investors, customers, employees, and the general public in the past ten years, with an incredible increase in focus over just the past year. This can be seen in the focus of the 2019 UN General Assembly, World Economic Forum,[12] the frequency of media headlines, and stakeholder activity. The external environment has indicated an increased urgency regarding corporate response to climate change and other ESG risks and expectations for corporate-led solutions on complex environmental and social issues. No longer confined to a small group of socially responsible investors, ESG issues have become a trend that "a reasonable shareholder would [likely] consider . . . important in deciding how to vote."[13]

Professor Fisch further notes that only about half of reporting companies disclosed climate change information in their annual filings, most of this information was boilerplate, and SEC's

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[8] 2010 Release at 6295 (citing SEC Interpretation: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Exchange Act Release Nos. 33–6835, 34-26831, 54 Fed. Reg. 22,427 (May 18, 1989)).

[9] *See* Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release Nos. 33-10751, 34-88094, 85 Fed. Reg. 10,568, 10,569 (Feb. 25, 2020).

[10] *Id.* The term "non-financial" is one of many used by experts to describe sustainability disclosure. *See* Fisch, *supra* note 2, at 931-32, n.40 (referencing a comment letter to SEC that referred to "non-financial factors" as being increasingly considered by investors in assessing companies' long-term performance.); *see also* 2010 Release at 6293 (tying "non-financial" to climate change).

[11] 85 Fed. Reg. at 10,570.

[12] In addition to the attention climate change and other ESG issues received at the January 2020 World Economic Forum Annual Meeting, the World Economic Forum recently issued a white paper that acknowledges the current materiality of ESG issues and encourages companies to begin developing systems to identify these factors *before* they arise as an indicator of a company's long-term strength. World Economic Forum, Embracing the New Age of Materiality: Harnessing the Pace of Change in ESG (Mar.2020), http://www3.weforum.org/docs/WEF_Embracing_the_New_Age_of_Materiality_2020.pdf.

[13] *TSC Indus., Inc.*, 426 U.S. at 449.

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enforcement of this insufficient reporting is lacking. [14] SEC's enforcement is beyond the scope of this comment, but the occurrence and quality of sustainability-related disclosures issues will likely evolve, if not in recognition of the flexible nature of SEC's MD&A, then in response to investor demands for climate and other ESG risks to be more deeply considered to aid investors in their decision-making.

Demand for Sustainability Disclosures Should Improve Quality

Professor Fisch opens the full article with the "'watershed moment'" quote from Larry Fink's 2018 letter to CEOs: "[A] company's ability to manage environmental, social, and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process."[15] This year, Mr. Fink expanded on his firm's expectations of companies by proclaiming that "climate risk is investment risk" and clarifying that companies' data describing how they are managing sustainability-related questions "should extend beyond climate to questions around how each company serves its full set of stakeholders, such as the diversity of its workforce [and] the sustainability of its supply chain . . . . Each company's prospects for growth are inextricable from its ability to operate sustainably and serve [all] stakeholders."[16] Indeed, Blackrock is now specifically asking companies that have not done so already to publish disclosures consistent with industry-specific Sustainability Accounting Standards Board ("SASB") guidelines and disclose climate-related risks consistent with the Task Force on Climate-Related Financial Disclosures ("TCFD") framework.[17] "In the absence of robust disclosures, investors, including BlackRock, will increasingly conclude that companies are not adequately managing risk."[18]

As investors coalesce around their preferred standards, more companies will need to disclose their sustainability issues and the resulting disclosures will be more accurate, comparable, and reliable.

Leveraging Enterprise Risk Management for ESG Disclosures

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[14] *See* Fisch, *supra* note 2, at 937, nn. 81-82. *See also* Thomson Reuters, *supra* note 6 ("The disclosure of material sustainability information is already required under Regulation S-K. Our research shows that information regarding 74 percent of SASB disclosure topics is already being disclosed in the Form 10-K, but 40 percent is boilerplate.").

[15] Fisch*, supra note* 2, at 924-25, n.3.

[16] Larry Fink, *supra* note 3. Just a few months prior to Mr. Fink's letter issuing, multiple large companies committed to the same vision of delivering value to all stakeholders. *See* Business Roundtable, Statement on the Purpose of a Corporation (Aug. 19, 2019), https://opportunity.businessroundtable.org/wp-content/uploads/2020/03/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf ("While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders [including customers, employees, suppliers, communities, and shareholders]. Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.")

[17] *See* Larry Fink, *supra* note 3.

[18] *Id.*

Even if adopted, Professor Fisch's SD&A would require an organization to appropriately assess its ESG risks in order to enable it to determine which three would be most significant. One barrier to the use of the existing MD&A for reporting ESG risks may be how companies assess these risks at the enterprise level.

The World Business Council for Sustainable Development[19] defines a sustainability risk as "an uncertain social or environmental event or condition that, if it occurs, can cause a significant negative [operational, financial and reputational] impact on the company."[20] Sustainability risks also include opportunities that may be available to a company because of changing environmental or social factors.[21] These risks and opportunities are often difficult to assess because of the complexity of the environmental and social issues involved, their long timeframes, which make determining probability and likelihood difficult, and because it is often difficult to precisely quantify impact, including financial impact.[22]

Even when these risks are recognized by a company, in many cases they may seem dwarfed by risks that are more immediate and directly related to the company's business. Thus, companies often overlook them when considering enterprise-level risk management[23] and these risks may be potentially further overlooked when considering "materiality"-based disclosures.

ESG disclosures under the existing SEC rules might be enhanced by companies including ESG issues, such as climate change, in their review of enterprise-level risks. Once included in a company's ERM system, assessing impact may become more systematic and focused[24] and may enable companies to better translate the impact of these risks and opportunities into the "materiality" thresholds applicable to SEC filings, which should result in better disclosures.

Conclusion

On the whole, more consistent and reliable sustainability reporting is needed. All stakeholders benefit from having decision-useful information and companies benefit from having a clear set of instructions for how to deliver that information whether in SEC filings or voluntary disclosures. But new regulation of sustainability disclosures is not necessary. SEC regulations already require disclosure of material sustainability risks and incorporating those risks into a

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[19] The World Business Council for Sustainable Development ("WBCSD") was established in 1995 to help businesses respond to sustainability challenges and currently works to accelerate the transition to a sustainable world by helping sustainable businesses become more successful. *See* WBCSD, About Us, https://www.wbcsd.org/Overview/About-us (last accessed Mar. 20, 2020).

[20] WBCSD, "Sustainability and enterprise risk management: The first step towards integration," at 7 (Jan. 17, 2017), https://www.wbcsd.org/Programs/Redefining-Value/Business-Decision-Making/Assess-and-Manage-Performance/Resources/Sustainability-and-enterprise-risk-management-The-first-step-towards-integration.

[21] *See id.*

[22] *See id.* at 25.

[23] *See id.* at 21.

[24] *See id.* at 38.

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company's ERM system could help companies better assess materiality. As investors continue to call for sustainability disclosures and align around specific reporting frameworks, companies will be required by their stakeholders to disclose the information needed to demonstrate that they are adequately managing sustainability risks regardless of SEC regulation.

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