Updates
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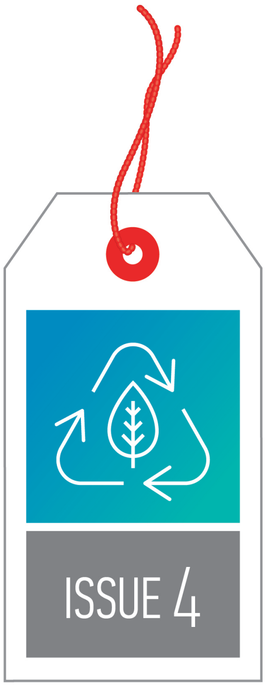
sclosures: What Is Material?



It is no surprise that more and more companies are issuing sustainability reports and broadly disclosing the effects of environmental, social, and governance (ESG) issues. A wide range of stakeholders are demanding this information, and many public companies are including some level of sustainability-related disclosures in periodic financial reports and proxy statements filed with the Securities and Exchange Commission (SEC). But for many companies, there is an open question as to what type of sustainability and ESG information is relevant and material to investors.

In this issue of the Perkins Coie Summer Sustainability Series, we discuss the debate over the materiality of ESG disclosures to investors and suggest action items for companies considering increased disclosures on these topics.

Framing the Materiality Debate

What Is Material?

Under U.S. securities laws, the well-established standard for materiality under *TSC Industries, Inc. v. Northway, Inc.* and *Basic Inc. v. Levinson* is that an omitted fact is material if there is a substantial likelihood that a reasonable investor would consider it important to their decision to buy or sell securities, or their decision-making in a shareholder vote. While it can sometimes be challenging for companies and their advisors to predict in advance whether certain information may ultimately be material to investors, practitioners have become accustomed to preparing investor-facing documents, such as financial reports and proxy statements, using materiality as a lens. Focusing that same materiality lens on ESG issues can present a more difficult challenge.

While there is no blanket SEC rule requiring disclosure of all material information about a company, failure to disclose material information in connection with the sale or purchase of securities creates the risk of both SEC enforcement and shareholder litigation. Public companies are also generally subject to anti-fraud requirements that prohibit misleading disclosures and material misstatements and must likewise comply with specific disclosure rules applicable to periodic and current reporting requirements, such as those included in Regulation S-K.

In the ordinary course of preparing reports for filing with the SEC, management will consider materiality in several ways. The legal and financial reporting team will review the risk factors included in the prior year's report and consider whether there have been changes to the business, industry, or general economic factors that are material and would require the company to add previously unknown or undisclosed risks to update disclosures. Similarly, the drafting team will consider whether there are any known trends or uncertainties that might affect future earnings in a significant manner, and therefore be material to investors. Other sections of periodic reports, including the business section and financial statements, are also reviewed with an eye toward updates for new material information. This process generally takes into account a variety of information, events, and trends. Historically, sustainability considerations and the broader ESG factors were peripherally considered, if at all. Today, however, it is increasingly acknowledged that there can be a positive return on sustainability investments as well as adverse costs incurred by failing to address environmental, human capital, corporate governance, diversity, and many other ESG issues. As such, these broader issues may also be material to a company's resiliency, access to capital, and overall value and success.

Under the existing U.S. regulatory approach, the primary question that is asked in making a materiality determination is whether the particular event, contingency, or trend has the potential to affect a company's financial condition or operating performance. This includes both potential short-term impacts (such as in the case of fines and penalties related to a pending legal matter) and long-term impacts (such as a change in technology that is expected to make a particular company's primary product obsolete). When it comes to ESG, the scope of contingencies that may be material becomes considerably broader and harder to quantify. Such factors include the potential impacts of rising sea levels and climate change, the challenges of supply chain compliance, and shortcomings in investments in human capital or corporate governance, to name just a few. The fact that it is hard or even uncertain, however, does not mean that these factors can be ignored.

Adding Sustainability to the Analysis: Double and Nested Materiality

Various approaches have been developed to help companies add ESG factors to their materiality analysis, including from the Group of Five reporting standards organizations - CDP, the Climate Disclosure Standards Board (CDSB), the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC), and the Sustainability Accounting Standards Board (SASB). These frameworks approach sustainability reporting from different perspectives, with some focused on encouraging disclosure on particular topics of interest to a broad set of stakeholders and others more focused on establishing standards for investor-focused reporting. They all generally recognize a distinction between traditional financial materiality and a related set of ESG materiality factors. Some ESG factors may be more material to companies in certain sectors over others, with the obvious example being carbon emissions in the energy sector. A key point to remember, however, is that the concept of materiality does not operate in a vacuum, and a broad set of ESG factors will impact the short- and long-term value of every company.

Double materiality is one way to conceptualize the different goals in the area of sustainability reporting. The European Commission (EC) discusses this concept at length in its 2019 "Guidelines on non-financial reporting, Supplement on reporting climate-related information," describing *financial materiality* as information that is "necessary for an understanding of the company's development, performance and position," and *environmental and social materiality* as information that is "necessary for an understanding of the external impacts of the company." These concepts are overlapping, but importantly under the EC's reporting requirements, companies must disclose information that is material from *either* of these perspectives. The EC's supplement also characterizes information that is financially material as being of interest to investors, while characterizing information that is environmentally and socially material as being relevant to consumers, civil society, employees, and investors.

The Group of Five reporting standards organizations have described a related concept of *nested materiality*. Nested materiality applies a gradated approach to reporting, starting from core financial information typically reported in periodic reports; to sustainability topics that are material for enterprise value creation; to a company's significant impacts on the economy, environment, and people. Significantly, this nested concept of materiality is also dynamic, in that considerations can move from the widest concept of general significance to financial materiality over time.

More than Materiality: The SEC Focus on Sustainability Disclosures

In early 2021, the SEC took multiple actions to signal an increased focus on sustainability, including climate change-related disclosures. Among other actions, the SEC announced that it would initially focus on perceived gaps in public company disclosures—highlighting the importance of making accurate disclosures regarding climate risks to or from a company's operations, as well as avoiding misstatements regarding other ESG factors. In addition, the SEC published a request for comment on potential climate change disclosure rulemaking, receiving over 640 letters in response, plus thousands of additional form letter submissions. In June, the SEC included in its annual regulatory agenda a proposal for rulemaking on climate risk disclosures, and further rulemaking on human capital management disclosures.

All of this SEC activity provides a strong indication that the SEC is considering rulemaking on particular ESG topics. As the SEC considers rulemaking, the SEC commissioners—and the broader conversation—have staked out two primary perspectives.

Commissioners Hester Peirce and Elad Roisman have expressed the position that the securities laws are not the appropriate mechanism for establishing sustainability-related metrics, and particularly not at this point in the development of sustainability reporting. They have expressed two primary concerns: first, that there are not yet market standard expectations among investors for sustainability-related topics and metrics. As Commissioner Peirce has said, "[a] single set of metrics will constrain decision making and impede creative thinking. Unlike financial accounting, which lends itself to a common set of comparable metrics, ESG factors, which continue to evolve, are complex and not readily comparable across issuers and industries."

Second, the commissioners have suggested that any ESG disclosure rulemaking that is not based in the traditional U.S. concept of materiality to investors goes beyond the current tripartite mission of the SEC to (1) protect investors, (2) maintain fair, orderly, and efficient markets, and (3) facilitate capital formation. They are not alone in taking this position, and as others have also noted, Congress can pass legislation calling on the SEC to make rules for disclosure of particular topics without regard to the significance of information to investors' investment and voting decisions, as they have done for CEO pay ratio and conflict mineral disclosures. But absent such a legislative mandate, Commissioner Roisman has suggested that the SEC should focus on its role as a federal securities regulator: "it should assess the merits of any potential disclosure requirements against the question of whether a reasonable investor would consider them material—that is, to a company's financial value."

On the other side of this debate, Commissioner Allison Herren Lee has argued that existing disclosure requirements for public companies have failed to result in companies disclosing all material sustainability information to investors, and that the SEC's authority to make rules regarding disclosure requirements is not qualified by materiality. Commissioner Lee notes that:

[O]ur statutory rulemaking authority under Section 7 of the Securities Act of 1933 gives the SEC full rulemaking authority to require disclosures in the public interest and for the protection of investors. That statutory authority is not qualified by "materiality." Similarly, the provisions for periodic reporting in Sections 12, 13 and 15 of the Securities Exchange Act of 1934 are not qualified by "materiality."

It should be highlighted that under the current administration, Commissioner Lee's position in this debate is in the majority among the SEC's five commissioners. Companies should therefore expect that rulemaking on ESG disclosures, particularly climate change-related disclosures, is a significant possibility in the near future.

Taking Action as the Debate Continues

As the theoretical debates over materiality, sustainability disclosures, and SEC rulemaking continue, what should public companies do? Many companies are hearing through investor engagement that their investors are interested in receiving additional information on sustainability topics. Other key stakeholders, including employees, customers, and local communities, are also calling for concrete ESG action. Companies are doing their own internal assessments and analyses of various sustainability-related issues. They are also setting corporate goals for metrics ranging from diversity, equity, and inclusion in the workforce and management to net-zero carbon emissions.

For companies preparing investor-facing disclosures on these topics and responding to other stakeholders, consider these six steps:

1. Identify those ESG issues that are important to the company's long-term success, including through engagement with multiple categories of stakeholders.
2. Prioritize issues for focus. Where are the company's greatest risks and most promising opportunities to have a positive impact?
3. Engage with investors to understand their perspectives on the company and its business and industry. Are there key topics or metrics that investors are requesting that the company has not identified as priorities through its internal assessments? Smaller companies may not be able to schedule direct engagement with significant investors. These companies can take cues from public statements and policies disclosed by such investors, and from sustainability reporting standard setters like SASB and IIRC.
4. Determine whether any sustainability-related topics should be discussed or addressed in SEC filings. Areas for consideration include SEC disclosure topics such as risk factors, discussion of known trends and uncertainties in management's discussion and analysis of financial condition and results of operations, the business section (including the recently added topic within this section of human capital management), and board oversight of risk in the annual proxy statement.
5. For disclosure topics and issues that the company decides do not rise to the level of materiality and therefore do not belong in an SEC filing, consider preparing a sustainability report or corporate webpage to increase transparency into the company's areas of focus, goals, and progress against those goals.
6. Carefully review and analyze all investor-facing disclosures for accuracy, completeness, and clarity—whether in SEC filings or in a separate sustainability report. While SEC filings may create greater risk of liability, companies should take care in any disclosures that could be relied upon by investors. One resource to consider is the SEC's guidance on disclosure of key performance indicators. Although that

guidance is targeted at operating performance metrics, the same recommendations— including disclosure of a clear definition of the metric and how it is calculated, stating why the metric provides useful information to investors, explaining how management uses the metric in managing or monitoring the business, and maintaining consistency across periods (or clearly explaining how the metric has changed)—apply to sustainability metrics. Companies should also take care to provide appropriate cautionary statements compliant with the PSLRA with respect to any forward-looking statements regarding sustainability goals.

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