

ESG Disclosure Mandate Faces Hurdles Regardless Of Path

By **Abigail Bortnick, Jennifer Guest and Matthew Wissa**

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The chorus demanding that companies disclose information regarding their environmental, social and governance impact has gotten louder in recent years and with the change in administration.

Underpinning those voices is the trend toward socially responsible investing — an investing strategy that considers how a company affects social issues, such as climate change or diversity, equally with whether the company will provide a return on investment.

To effectuate this strategy, investors have called for the U.S. Securities and Exchange Commission to explicitly require all companies to report on these social issues in quarterly and annual reports, proxy statements, and other public filings. These latest efforts have come directly from President Joe Biden, the SEC and, most recently, the U.S. House of Representatives.

On June 16, the House narrowly passed H.R. 1187, the Corporate Governance Improvement and Investor Protection Act, a collection of several bills that would require companies to publicly disclose substantial ESG metrics in various issuer materials.

Principally of note is the ESG Disclosure Simplification Act of 2021 and the Climate Risk Disclosure Act, both of which would amend the Securities Exchange Act and direct the SEC to engage in rulemaking to set out the requirements for standardized ESG disclosures should H.R. 1187 become law.

H.R. 1187 faces an uphill battle in the U.S. Senate. But even if H.R. 1187 does not become law, the SEC may decide to go it alone. Recent developments at the SEC, including comments by SEC Chair Gary Gensler, suggest that the commission may undertake rulemaking around ESG disclosures without a congressional mandate.

Corporate Governance Improvement and Investor Protection Act

On Feb. 18, Rep. Juan Vargas, D-Calif., introduced H.R. 1187. On June 16, the House narrowly passed H.R. 1187, largely along party lines. Following its passage, the bill was received in the Senate and



Abigail Bortnick



Jennifer Guest



Matthew Wissa

referred to the Committee on Banking, Housing and Urban Affairs.

H.R. 1187 includes 11 titles that address various areas of corporate disclosures. Title 1, the ESG Disclosure Simplification Act, requires the SEC to engage in rulemaking to define exact ESG disclosure standards.

The act also requires public filers to provide "a description of any process the issuer uses to determine the impact of ESG metrics on the long-term business strategy of the issuer." The act clarifies that the ESG metrics, as will be defined by the SEC, will be de facto material for the purposes of disclosures.

Title 4, the Climate Risk Disclosure Act, in part, directs the SEC to promulgate climate-related risk disclosure rules for certain enumerated industries, including finance, insurance and nonrenewable energy, and requires the SEC to promulgate rules for "any other sector determined appropriate by the Commission."

Title 4 also lays out specific disclosure requirements, including: the identification, evaluation and risk management strategies relating to the risks posed by climate change; the actions the issuer is taking to mitigate climate-related risks; and a description of how climate risk is incorporated into the issuer's overall risk management strategy.

Will ESG Disclosures Become a Reality?

Despite the ambitious efforts of the House, it is unlikely the act will pass in the Senate. Republicans on the Senate Banking Committee have already expressed their opposition to further ESG disclosures in a public letter to the SEC.

Additionally, the act passed the House by the narrowest of margins, with four Democrats voting against it. Moderate Senate Democrats may follow suit.

Even if Congress does not pass the act, there is mounting evidence that the SEC will unilaterally act to require issuers to include ESG data in public disclosures.

Whether the SEC has the authority to do so without explicit congressional authorization is up for debate.

Those who support unilateral SEC rulemaking argue that there is no need for an official delegation of congressional authority in order for the SEC to expand disclosure obligations.[1] Rather, the SEC can dictate what information issuers are required to disclose under the Securities Act and the Securities Exchange Act.[2]

Opponents argue that the SEC cannot require issuers to disclose such information without, at minimum, a congressional statute authorizing them to do so because such disclosure obligations "would be different from the kind of disclosure requirements Congress permitted the SEC to write." [3]

One point of contention between those who support SEC action on ESG issues and those who do not is the debate over whether such information is material.

In a frequently cited 1976 U.S. Supreme Court opinion, *TSC Industries Inc. v. Northway Inc.*, Justice Thurgood Marshall defined "material information" as that which a reasonable investor would consider important to know in making an investment or voting decision.

Many who argue that the SEC should not, and cannot, adopt ESG disclosure requirements do so on the basis that such information is not material.[4]

Supporters of unilateral SEC action counter that the SEC is not limited by the concept of materiality in dictating disclosure requirements,[5] but even if it was, information about a company's environmental impact, diversity and political contributions is information that investors do find financially material.[6]

The SEC certainly believes that it has the authority to unilaterally broaden reporting requirements to include ESG disclosures, and recent events indicate that it intends to do so.[7]

Gensler has made repeated public statements supporting new rulemaking requiring disclosure on climate risks, as well as advocating for increased transparency surrounding sustainability and diversity claims by asset managers.

The SEC also requested public comments on whether current disclosure obligations "adequately inform investors about known material risks, uncertainties, impacts, and opportunities and whether greater consistency could be achieved." [8]

Finally, in February of this year, the SEC announced the appointment of Satyam Khanna as the first senior policy adviser for climate and ESG, tasked with "advis[ing] the agency on environmental, social, and governance matters and advanc[ing] related new initiatives across its offices and divisions." [9]

Even if the SEC Acts, Will Rulemaking Be Successful?

Even if the SEC successfully finishes the rulemaking process, it will likely be many years before issuers will have to disclose ESG information in their annual and quarterly reports. Any successful rulemaking will likely be met with a flurry of lawsuits, and may even fall victim to congressional action.

Previous efforts by the SEC to effectuate politically sensitive rulemaking offer insights into what may await any new ESG disclosure requirements.

In 2010, as part of the Dodd-Frank Act, Congress passed Section 1504 directing the SEC to issue rules requiring resource-extraction issuers to disclose payments made to the U.S. or foreign governments for the commercial development of oil, natural gas or minerals.[10]

The SEC attempted to issue final rules three times. Its first attempt in 2012 was opposed by industry groups, who successfully challenged the rules before the U.S. District Court for the District of Columbia in *American Petroleum Institute v. SEC* in 2013.[11]

The SEC issued the rules a second time in 2016, but was again met with resistance, this time from Congress. On Feb. 14, 2017, for only the second time under the Congressional Review Act, Congress disapproved the rules by a joint resolution.[12]

On Dec. 16, 2020, the SEC voted for a third time to adopt final rules.

The SEC's tortuous path to comply with Section 1504 shows some of the pitfalls that may befall future efforts to issue rules governing ESG disclosures. Like Section 1504, H.R. 1187 faces strong partisan and industry opposition.

Any rulemaking will be subject to lawsuits, and a change in congressional leadership could result in the rules being subject to scrutiny under the CRA. Further, the political scrutiny that the rules will face may result in disclosure obligations that fall short of the goals set by the act and Gensler.

Indeed, critics argue that the SEC's third attempt to pass rules for resource-extraction issuers falls far short of meeting the transparency and anti-corruption goals that Section 1504 was enacted to achieve.

Experience suggests that the road to final rules requiring ESG disclosures will be a long and difficult one, whether the impetus for such rulemaking comes from Congress or the commission itself. Even without such rules, the evidence suggests that investors are increasingly moving away from issuers who do not publish this information or make ESG-related issues part of their governing mandate.

As a result, it is increasingly likely that issuers will begin to disclose such information, either because they need to do so to raise new capital or because they have determined that the information is now material to investors.

Without standardized definitions or disclosure obligations clearly outlining what information investors can expect to receive, however, it is unclear how effective such disclosures will be.

Abigail N. Bortnick is counsel, Jennifer C. Guest is a senior associate and Matthew T. Wissa is an associate at King & Spalding LLP.

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[1] See, e.g., Alexandra Thornton and Tyler Gellasch, The SEC has Broad Authority to Require Climate and Other ESG Disclosures, Center for American Progress (June 10, 2021), <https://www.americanprogress.org/issues/economy/reports/2021/06/10/500352/sec-broad-authority-require-climate-esg-disclosures/>.

[2] What We Do, SEC, available at <https://www.sec.gov/about/what-we-do> (last visited Aug. 26, 2021); Business and Financial Disclosure Required by Regulation S-K, Exchange Act Release No. 33-10064, 2016 WL 1458170, 22-27, 204-05 (Apr. 13, 2016) (citing 15 U.S.C. 77g)(providing that under Section 7 of the Securities Act, the SEC "may exercise its rulemaking authority to prescribe additional information ... as it deems necessary or appropriate in the public interest or for the protection of investors").

[3] Andrew N. Vollmer, Mandatory Disclosure Rules on Climate Change are a Job for Congress, not the SEC, The Hill (Jul. 31, 2021), <https://thehill.com/opinion/finance/565782-mandatory-disclosure-rules-on-climate-change-are-a-job-for-congress-not-the>.

[4] For example, in a speech before the National Investor Relations Institute on June 22, Commissioner Elad Roisman expressed skepticism that ESG information is material to investors. Elad L. Roisman, Comm'r, SEC, Can the SEC Make ESG Rules that are Sustainable? (June 22, 2021), https://www.sec.gov/news/speech/can-the-sec-make-esg-rules-that-are-sustainable#_ftnref6.

[5] See, e.g., Alexandra Thornton and Tyler Gellasch, The SEC Has Broad Authority To Require Climate

and Other ESG Disclosures, Center for American Progress (June 10, 2021), <https://www.americanprogress.org/issues/economy/reports/2021/06/10/500352/sec-broad-authority-require-climate-esg-disclosures/> ("Nowhere in the Securities Act of 1933, the Securities Exchange Act of 1934, their legislative histories, or case law is the SEC's authority to mandate disclosures limited to just information that is deemed material to investors. Indeed, to impose such a limit now would effectively repeal a significant and increasingly important part of U.S. federal securities laws that not only protects investors directly, but also provides for more fair, orderly, and efficient markets, promotes capital formation, and in so doing, protects the public interest."); Letter from Heather Slavkin Corzo, Director, AFL-CIO, to Brett J. Fields, Secretary, SEC at 9 (July 21, 2016), <https://www.sec.gov/comments/s7-06-16/s70616-305.pdf> ("Materiality,' the dominant principle in our disclosure regime, defines the floor below which reporting becomes fraudulent. It is the catchall, a backstop, the 'at a minimum' safety provision. It is not the driving force of our disclosure regime. The '33 and '34 Acts charge the commission with establishing a disclosure regime to protect investors and our markets. It cannot achieve this by focusing merely on what would constitute fraud.").

[6] Letter from Securities Law specialists to Brett J. Fields, Secretary, SEC at 6 (Oct. 1, 2018), available at <https://www.sec.gov/rules/petitions/2018/petn4-730.pdf>.

[7] Business and Financial Disclosure Required by Regulation S-K, Exchange Act Release No. 33-10064, 2016 WL 1458170, 22-27, 204-05 (Apr. 13, 2016).

[8] <https://www.sec.gov/news/public-statement/lee-climate-change-disclosures>.

[9] <https://www.sec.gov/news/press-release/2021-20>.

[10] Nicholas Grabar and Sandra L. Flow, Congress Rolls Back SEC Resource Extraction Payments Rule, Harvard Law School Forum on Corporate Governance (Feb. 16, 2017), <https://corpgov.law.harvard.edu/2017/02/16/congress-rolls-back-sec-resource-extraction-payments-rule/>.

[11] https://assets.ctfassets.net/t0ydv1wnf2mi/GOFOD6wKdhYln6xxRn9nT/ffdc99c64ea0e0d875959764dc7c297e/federal_court_vacates_the_sec-section_1504_reporting_requirements_for_payments_to_governments_by_oil_gas_and_mining_comp.pdf

[12] Peter Rasmussen, Analysis: SEC Tries to Solve CRA Conundrum on Resource Payments, BLOOMBERG LAW (Jan. 7, 2020), <https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-sec-tries-to-solve-cra-conundrum-on-resource-payments>.