Speech

Putting the Electric Cart before the Horse:[1] Addressing Inevitable Costs of a New ESG Disclosure Regime

Commissioner Elad L. Roisman

Washington D.C.

June 3, 2021

I. Introduction

Thank you to Dan [Bigman] and the Corporate Board Member for inviting me to participate in today's ESG Board Forum. Of course, the views I express here are my own and do not necessarily represent those of my fellow Commissioners.

As the topic of this event indicates, ESG is on everyone's mind this year. There have been several calls for the SEC to require public issuers to include granular disclosure on ESG topics in their SEC filings. As you have probably heard me say before,[2] I have reservations about the SEC issuing prescriptive, line-item disclosure requirements in this space, particularly in the areas typically designated as environmental ("E") or social ("S") disclosure, although I know people's categorization of ESG information can vary.[3] As someone recently put it to me, the reason that there is not standardized "E" data from companies yet is that standardization is very hard to do. Investors and fund managers have an insatiable desire for columns in spreadsheets, but some of the data that has been requested is inherently imprecise, relies on underlying assumptions that continually evolve, and can be reasonably calculated in different ways. And ultimately, unless this information can *meaningfully* inform an investment decision, it is at best not useful and at worst misleading.

A. Critical Questions

I feel like a broken record, but our disclosure framework already requires public issuers to provide information that is material to investors,[4] including information one might categorize as "E," "S," or "G."[5] The Commission has explicitly interpreted our rules to require disclosure of the material effects of climate change on a business.[6] We also amended Regulation S-K last year to require disclosures regarding human capital.[7] To the extent that other *material* risks to a company can be categorized as "E," "S," or "G," I do not see a legal justification for failing to disclose that information under our existing rules.

But, the SEC Chair has made clear that further ESG disclosure is an area that the agency will pursue.[8] So, I want to take this opportunity to set out some of the main questions I have about these initiatives—and I believe these are questions that the Commission will have to grapple with in promulgating any new rules requiring ESG disclosure:

1. What precise items of "E," "S," and "G" information are investors not getting that are material to making informed investment decisions?

2. It seems that some of the interest, particularly in "E" and "S" disclosures, is not in what risks environmental or social factors pose *to the company*, but rather what risks the company poses to, for example, the climate. To the extent that the interest is in understanding risks the company poses to the climate, what makes *the SEC* the appropriate federal government agency to require these disclosures, as opposed to, for example, the Environmental Protection Agency?
3. How would the SEC come up with "E" and "S" disclosure requirements—now, and on an ongoing basis? What expertise is needed?
4. Some have advocated that the SEC try to incorporate the work of external standard-setters. That idea raises additional questions. How would the agency oversee them—in terms of governance, funding, and substantive work product—on an ongoing basis? What kind of new infrastructure would be required inside the SEC and at the standard-setters themselves?[9]
5. **If the Commission were to come up with the type of information that we hope to have companies disclose, how should we tailor our requirements to balance the benefits we are looking to achieve with such rules' inevitable costs?**

It is this *last* question that I am going to focus on today. Let me first make clear, however, that I am not starting with this question because it is more important than the other questions. Again, I think the Commission, if it undertakes to develop such proposed rules, will have to answer *each* question, and they are all incredibly challenging. It probably will not surprise many of you that I still have concerns about the SEC acting in this space, and I am looking to public comments and welcome engagement on each of the questions I have presented. Today, I want to talk about potential costs of *any* new ESG disclosure regime and ways to mitigate them because I realize that the agency has such rules in process,[10] and I believe this discussion is relevant, regardless of how the Commission approaches the other questions I have asked.

So, let me now proceed to put the electric cart before the horse and talk about the various costs and difficulties that would inevitably come from new line-item disclosure requirements in the areas of ESG and how the SEC might address them to make the regime workable for companies and to benefit investors.

II. Minimizing Costs and Burdens

In all rulemakings the Commission undertakes, we must consider expected costs and benefits.[11] Specifically, we must weigh these against each other and work to mitigate costs and burdens to the extent they are not justified by benefits we aim to achieve. As I have indicated in my questions about materiality, I have been looking to better understand potential benefits, such as what "E" and "S" line-item information investors want in order to inform their investment decisions.

A. Foreseeable Costs

The costs are more obvious. Any new disclosure requirement causes companies to incur costs in obtaining and presenting the new information. Beyond the costs of collecting (and in some cases, calculating) and preparing the information for submission are the costs of increased liability for making such disclosures.[12]

None of these cost categories are necessarily unique to ESG disclosures. They may, however, be greater given both the potential scope and novelty of the "E" and certain "S" categories in particular. Also, to the extent that any new requirements call for information beyond our existing materiality standards, these costs could be even higher. The advantage of foreseeing costs is that we can do something to head them off—and I believe the SEC will have the obligation to do just that if the goal is to craft a proposal that gets ESG information into the hands of investors.

B. Ways to Tailor ESG Disclosure Requirements

1. Scaled Disclosure for Public Issuers

Costs of obtaining and presenting new disclosures will be proportionally greatest for smaller companies that have scarce resources and are trying to grow. They will similarly be high for less mature companies that are trying to develop and refine their business models.

Scaling the new disclosure requirements could lighten the burden on smaller companies, and we have taken this approach in many of our existing disclosure requirements.[13] (See further discussion of potential accommodations for smaller companies in Section 5 below.) Although some have suggested that, in enacting new ESG disclosure requirements, we take the unprecedented step of imposing the requirements on public and non-public companies alike,[14] I think any new requirements should be limited to public companies—those that have undertaken the regular public reporting that our regime requires.

2. Flexibility in Sources and Methodologies

We also will need to be reasonable in our expectations of what companies can disclose and how they disclose it. For example, a good amount of "E" information is difficult to calculate, and sources for it are not always reliable. Scope 3 greenhouse gas emissions are a prime example; the company's ability to calculate Scope 3 emissions depends on it gathering information from sources wholly outside the company's control, both upstream and downstream from its organizational activities.[15]

We should not expect an unreasonable degree of precision in these disclosures (and therefore strict liability). I worry that, for most "E" information, companies will have to go to outside vendors to evaluate and obtain some of this information and that our regulations will inflate demand—and cost—for such data.[16] I believe that we should allow issuers flexibility in how they present much of this new disclosure, recognizing these limitations.

Similarly, I would have concerns about subjecting any such new requirement to heightened verification measures—such as an audit or an attestation.[17]

3. Safe Harbors

Next, I think the Commission will have to address the inevitable litigation risk that will come with such sweeping new disclosure requirements. Costs surrounding private securities litigation have increased tremendously in the last decade.[18] I worry that if we were to add a slew of new disclosure requirements—especially requirements that are not based on a materiality standard—we would expose companies (and their investors), boards, and management to numerous costly lawsuits when they are merely trying to provide information to satisfy a regulatory requirement. How can we balance the desire for new disclosure with the liability of providing estimates?

I would advocate we consider a safe harbor for companies that are earnestly trying to provide this new information, along the lines of that which is available for companies' forward-looking statements. We would be asking companies to tell us what they know, as best as they can discern it.[19] I worry we would chill that effort if we did not provide them some space to provide that disclosure.

4. Furnished, not Filed

Given the litigation risks inherent in requiring new disclosures in areas that are still evolving, I think the Commission should consider whether such disclosures should be furnished to the agency, rather than filed. This would track the approach we recently adopted with regard to disclosure of payments related to resource extraction.[20] To the extent that the argument for the SEC to require additional "E" and "S" disclosures is that investors want the information and they benefit from the uniformity and comparability that SEC-required disclosures would provide, those benefits can be realized without imposing the level of liability that filing with the SEC presents.

5. Extended Implementation Period

Finally, I think that such a new disclosure regime will have to be phased in and have an extended implementation period. Companies will inevitably be looking back to the Commission for guidance about what level of detail and scope of information meets our requirements; they will also look at other companies' disclosures for ideas on how to improve their own. This is another reason to treat companies of different sizes differently, given that smaller companies will want to see what larger ones do. It is reasonable that companies could take different approaches to their disclosures, and such variation could benefit investors, who can then express preferences back to issuers. I hope that we can be patient in how we choose to implement this new regime in order to allow this natural process to occur. We could phase in particular requirements and allow smaller companies a longer implementation period. Regardless of how we tailor this aspect of the rules, we should certainly allow a good amount of time for the compliance measures to develop before we bring any enforcement actions.

III. Conclusion

In summary, any new ESG disclosure rules will inevitably come with costs. Especially since such disclosure would involve information that is based on uncertain underlying assumptions, or is difficult to calculate, the Commission should be particularly careful to ensure that (1) investors understand the limitations of the information disclosed and (2) companies can actually provide such information without incurring undue costs and burdens. I hope the Commission can predict these costs clearly enough to mitigate them in our rulemaking process. From my perspective, this can only help meet the stated objectives of any potential ESG disclosure proposal—that is getting this new information to investors.

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[1] Credit to Steven Lofchie for this apt metaphor. Cadwalader Cabinet (March 5, 2021), https://www.findknowdo.com/newsletter/template/544449.

[2] Commissioner Elad L. Roisman, "Keynote Speech at the Society for Corporate Governance National Conference" (July 7, 2020), https://www.sec.gov/news/speech/roisman-keynote-society-corporate-governance-national-conference-2020.

[3] For example, I have heard some categorize information about the diversity characteristics of corporate boards or data on companies' political spending as governance (or "G") factors. Yet, I have heard others reference each of those as falling within the "S" category.

[4] *See supra note* 2.

[5] Although the Commission may not have explicit disclosure requirements for certain types of information, to the extent that such information relates to a material risk to the company (such as, for example, its financial condition), Item 105 of Regulation S-K requires a company to disclose "the most significant factors that make an investment in the registrant or offering speculative or risky." Moreover, to the extent such information is reasonably likely to have a material impact on future operations, the company would have to disclose it. Item 303, the Management's Discussion and Analysis, requires the company to "provide material information relevant to an assessment of the financial condition and results of operations" including "matters that are reasonably likely based on management's assessment to have a material impact on future operations" of the registrant including "financial condition, changes in financial condition and results of operation." In addition to specified information, the company must include "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." 17 C.F.R. §§ 229.105 and 229.303. These disclosure requirements are merely examples, as there are several more requirements that would elicit similar disclosures of material information.

[6] *See* "Commission Guidance Regarding Disclosure Related to Climate Change," Rel. No. 33-9106 (Feb 8. 2010), https://sec.gov/rules/interp/2010/33-9106.pdf.

[7] *See* Modernization of Regulation S-K Items 101, 103, and 105, Rel. No. 33-10825 (Aug. 26, 2020), https://www.sec.gov/rules/final/2020/33-10825.pdf.

[8] Chair Gary Gensler, "Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee" (May 26, 2021), https://www.sec.gov/news/testimony/gensler-2021-05-26 (*hereinafter* "Chair Gensler Testimony").

[9] We currently rely on the work of the Financial Accounting Standards Board or "FASB" to set accounting standards. We have a very close working relationship with this body, which has taken many decades to develop, and which involves regular and ongoing work with our Office of the Chief Accountant.

[10] *See* Chair Gensler Testimony, *supra* note 8.

[11] *See* Memorandum "Current Guidance on Economic Analysis in SEC Rulemakings" (March 16, 2012), https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

[12] In addition to the enforcement risk, companies face private civil lawsuits, alleging material misstatements and omissions in public disclosures. New disclosures present new opportunities for such lawsuits, especially because any new requirements inevitably include some unforeseen ambiguities that provide openings for resolution through litigation. *See also* note 18 *infra*.

[13] *See* 17 C.F.R. § 229.10(f), listing the disclosure items for which alternate disclosure options exist for smaller reporting companies. In addition, the Commission could elect to provide a delayed compliance option for smaller companies. *See*, *e.g.,* FAST Act Modernization and Simplification of Regulation S-K, Rel. No. 33-10618 (Mar. 20, 2019) (compliance phased in for large accelerated filers, accelerated filers, and all other filers on different dates to provide more time for smaller companies to implement needed changes).

[14] *See* Acting Chair Allison Herren Lee, "Public Input Welcomed on Climate Change Disclosures," https://www.sec.gov/news/public-statement/lee-climate-change-disclosures ("Acting Chair Lee's Request for Comment on Climate Disclosure"). (Question 14 asks "What climate-related information is available with respect to private companies, and how should the Commission's rules address private companies' climate disclosures, such as through exempt offerings, or its oversight of certain investment advisers and funds?")

[15] *See* U.S. Environmental Protection Agency, Center or Corporate Climate Leadership, "Scope 3 Inventory Guidance," https://www.epa.gov/climateleadership/scope-3-inventory-guidance.

[16] This appears to be occurring in Europe, where there has been regulatory pressure on institutional investors to incorporate ESG information into their investment process. According to one research firm, annual spending on ESG data was estimated at $617 million in 2019 and projected to be over $900 million in 2020. *See* Opimas, "ESG Data Market: No Stopping Its Rise Now" (March 3, 2020), http://www.opimas.com/research/547/detail/. Sixty percent of this spending was identified with firms doing business in Europe, with North America accounting for roughly a third of the market. *Id*.

[17] *See* Acting Chair Lee's Request for Comment on Climate Disclosure (Question 10 asks about potential audit or assurance requirements. Question 11 asks about certifications by corporate executives.)

[18] Both the total number of securities class action claims filed annually and the costs to defend and settle such claims have increased over the past ten years. Chubb, *From Nuisance to Menace: The Rising Tide of Securities Class Action Litigation* (June 2019), http://news.chubb.com/download/From+Nuisance+to+Menace+-+The+Rising+Tide+of+SCAs+-+Chubb.pdf, at 3-6. *See also* U.S. Chamber Institute for Legal Reform, *A Rising Threat The New Class Action Racket That Harms Investors and the Economy*, 18 (2018); Alexander Aganin, Cornerstone Research, "Securities Class Action Filings—2019 Year in Review" (Feb. 14, 2020), https://corpgov.law.harvard.edu/2020/02/14/securities-class-action-filings-2019-year-in-review. This trend has raised premiums companies pay for directors and officers (or "D&O") insurance; in 2020, D&O premiums rose over 40% from the prior year. S&P Global Market Intelligence, "D&O premiums rise 41% YOY in 2020; loss ratios hold steady" (May 5, 2021), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/d-o-premiums-rise-41-yoy-in-2020-loss-ratios-hold-steady-63997938.

[19] For example, Section 27A(c) of the Securities Act of 1933 provides safe harbor from liability for a forward looking statement that is "identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward looking statement[.]" New ESG disclosure requirements could provide safe harbor for statements that included similar caveats. As with forward-looking statements, anti-fraud provisions, such as Rule 10b-5, would still apply. 17 C.F.R. § 240.10b-5.

[20] *See* Disclosure of Payments to Resource Extraction Issuers, Rel. No. 34-90679, (Dec. 16, 2020), https://www.sec.gov/rules/final/2020/34-90679.pdf.