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"Materiality" may be the key to getting stakeholder capitalism to work. But what does it mean?

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The future of ESG – integrating environmental, social and governance factors in investing – appears to hinge on the concept of "materiality."

Securities and financial regulators in the U.S. are debating whether and how to guide the disclosure of information relating to corporate ESG activities. European regulators have already taken action, providing guidance through the EU Non-financial Reporting Directive and the Sustainable Finance Disclosure Regulation, among a number of other rules. For the U.S. SEC, if they are to mandate disclosure of certain corporate activities relating to ESG, an analysis of whether those items are "material" to a reasonable investor has become the analytical lynchpin.

Yet, the definition of materiality is and always has been slippery. Current law appears to require, at a minimum, that companies shall disclose all matters, including ESG matters, that are material to a reasonable investor. What constitutes "material," "reasonable," and even at times "investor" isn't always clear.

Regulators are important to the durability of ESG as an investment strategy because mandatory rules or guidance can help mitigate greenwashing, pushing companies to ensure that their communications, reports, and other formalized disclosures accurately reflect their actual business practices and strategies. Moreover, investors will be able to access comparable data about the intangibles in business, sometimes called non-financial behavior, which will help them differentiate among companies' abilities to manage these emerging risks.

What's at stake is whether advocates for ESG can provide a defensible rationale for why activities or decisions that used to be considered externalities in business are indeed issues that companies should be responsible for in their own operations. These externalities include environmental issues like greenhouse gas emissions, as well as labor rights and fair wages, among a host of other topics. Many of these areas are not directly regulated on the substance, and therefore securities regulation could impose duties above and beyond existing laws.

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Employee satisfaction is a good example in this context. While historically companies considered it nice to have satisfied employees – a happy worker can be a harder worker – labor was primarily viewed as fungible and secondary to other strategic assets. Companies today, however, increasingly view employee retention as a key priority. Even before the pandemic's impact on tight labor markets, competition for qualified workers was on the rise. Thus, the salient question for corporate disclosure is whether employee satisfaction and retention are "material" to business operations, as has been demonstrated by academic research.

Despite evidence of the link between employee satisfaction and company performance, when it comes to human capital disclosures, few companies disclose meaningful information to satisfy investor needs. Some will cite practices such as their employee surveys or corporate values statements about respect and compassion. But this hasn't satisfied investors, who continue to ask for more specificity. The information they seek is arguably not so onerous. The Human Capital Management Coalition, a cooperative effort led by a number of investors and asset managers, has boiled it down to four foundational reporting elements, such as the total number of employees (including independent contractors), employee turnover/retention rate, the total cost of the workforce, and diversity data.

Among the SEC Commissioners who have recently opined on materiality, Commissioner Pierce has made the point that there isn't a need for additional SEC rules on this topic. She indicates that "if ESG opportunities are driving management decision-making, our existing disclosure rules also pull those in." Others, such as past Commissioner Roisman have also indicated his view that materiality should be the "touchstone" for additional disclosure guidance from the SEC, but questions whether the market is mature enough for SEC guidance to meaningfully address needs beyond the information already available.

This view, that material ESG information from corporate issuers is already mandated, seems to be accurate in principle. For example, Regulation S-K requires that the company disclose its sources of raw materials, its competitive position, or pending legal proceedings, other than routine litigation. Additionally, the 2010 SEC Guidance Regarding Disclosure Relating to Climate Change should have helped address some gaps relating to whether and how environmental and climate matters are material risks for investors.

Commissioner Lee, however, believes that it's a myth that the securities law imposes a spontaneous obligation on companies to disclose all ESG matters, or indeed all general matters material to investors. She advocates that the market needs guidance relating to ESG matters such as climate change and human capital management because "there is no general requirement under the securities laws to reveal all material information." Moreover, even when there is a duty to disclose a specific item, business managers and their lawyers and auditors must judge what rises to the definition of materiality. Thus, further guidance on these emerging risks is warranted.

The Department of Labor (DOL) proposals on ERISA plan fiduciary's responsibilities with respect to ESG also suggests that there is a lack of clarity among market participants. The October 2021 DOL proposed regulations state the Department's view that "in many instances … an evaluation of the economic effects of climate change on the particular investment or investment course of action" is required. This could be interpreted as a requirement that the impact of climate change on all plan assets be calculated and considered. The DOL has made it clear that use of plan assets to further political and social causes is prohibited, thus requiring that any analysis be limited to financially material impact.

Even if there were consensus that mandatory disclosure of material ESG risks is warranted, the concept of materiality can prove elusive. The prevailing SEC definition, which has endured since a U.S. Supreme Court decision from the 1970s, is more of a general principle rather than a specific requirement. The principle is that managers should disclose information if there is "a substantial likelihood" that it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

Moreover, there are emerging qualifiers around materiality today, such as economic materiality, qualitative materiality, double materiality, and dynamic materiality. Some, like economic materiality, assess impact of a matter on the company's financial situation, while double materiality considers effects both on the company as well as on people and the planet. The latter concept of double materiality has been embedded into the EU Non-financial Reporting Directive, which established principles for reporting of corporate sustainability information in Europe. In addition, ESG is an umbrella for a number of disparate issues ranging from human rights to labor rights to climate change, not all of which can be consistently boiled down to quantitative and material risk.

What's clear is that investors seek more decision-useful information that could serve as leading indicators of whether a management team has a good grip on the uncertain future ahead. Whether those environmental and social challenges can be refracted through the lens of materiality remains on the U.S. regulatory agenda for the time being.