SULLIVAN & CROMWELL LLP

June 8, 2020

The Rise of Standardized ESG Disclosure Frameworks in the United States

Recent Developments Regarding Frameworks Developed by the Sustainability Accounting Standards Board, the Task Force on Climate-Related Financial Disclosures and Other Standard-Makers

SUMMARY

Over the last several years, U.S. public companies have faced increasing pressure from investors and other stakeholders to disclose their environmental, social and governance ("ESG") risks, practices and impacts. In the last few years, with more U.S. public companies publishing sustainability reports[1] and other ESG disclosures, some investors have expressed concern that the lack of a standardized ESG disclosure framework, which makes it difficult for investors to meaningfully evaluate and compare companies' ESG practices and risks, reduces the value of such disclosures.

Although a number of ESG disclosure standards have been developed and some have been incorporated into mandatory reporting regimes by non-U.S. regulators, any implementation by a U.S. company of an ESG disclosure framework remains voluntary at this time. Despite several proposals in 2019 from U.S. federal lawmakers on ESG disclosure requirements (which have not been adopted to date), the Securities and Exchange Commission's ("SEC") January 2020 proposed amendments to the MD&A rules did not include requirements for specific ESG or climate-related disclosures. SEC Chairman Jay Clayton and Commissioner Hester Peirce issued statements reaffirming the existing principles-based, materiality-focused approach the Commission adopted in its 2010 guidance,[2] and highlighted threshold issues that pose challenges to imposing a standardized ESG disclosure regime, including the complex landscape surrounding ESG disclosures and the forward-looking nature of climate-related ESG disclosure.[3] However, U.S. public companies are facing mounting pressure from investors—including influential institutional investors such as BlackRock, Vanguard and State Street, which have indicated in public statements in the

past year that they are in support of companies making ESG disclosures aligned with both the Sustainability Accounting Standards Board ("SASB") and Task Force on Climate-Related Financial Disclosures ("TCFD") frameworks[4]—to voluntarily adopt certain ESG disclosure standards, especially the SASB and the TCFD frameworks, which have gained particular traction in the United States. In light of the increased investor attention and the lack of a mandatory framework, it is important for U.S. issuers to closely monitor developments in this area, and consider whether the voluntary adoption of an ESG disclosure standard makes sense in light of the issuer's specific circumstances—e.g., the views of its investors, the costs and benefits of implementation and feasibility of establishing adequate internal controls over any such disclosure—before implementing any such framework.

For ESG disclosure considerations in the EU, see our memo on recent developments, available here.

OVERVIEW OF ESG DISCLOSURE FRAMEWORKS

Companies considering the potential implementation of an ESG disclosure framework should be aware of the variety of reporting standards that have been developed by standard-makers around the world. Different standard-makers address different cross-sections of ESG issues and have different concepts of what factors are material:

- **SASB:** The SASB framework provides sector-specific guidance on a broad range of ESG topics, covering issues such as greenhouse gas ("GHG") emissions, energy and water management, data security and employee health and safety, while providing sector-specific guidelines emphasizing topics SASB believes are material for issuers in those sectors. An overview of the SASB framework is available here.
- **TCFD:** Unlike the SASB framework, the TCFD framework provides both general and sector-specific guidance, but only on climate-related topics, such as physical risks of the effects of climate change and climate-related opportunities, including those related to resource efficiencies and alternative energy sources. The TCFD framework has been endorsed and incorporated into mandatory reporting regimes by regulators in the EU, United Kingdom and Hong Kong. The TCFD's final report providing disclosure recommendations is available here.
- **Other Frameworks:** Other ESG disclosure frameworks have gained traction among market participants, including the Global Reporting Initiative ("GRI"). Some of these standard-makers approach the concept of materiality in ways that are notably differently from the SASB and TCFD, whose frameworks focus on information they consider to be *financially* material (though both recognize that issuers are best positioned to determine which standards are financially material to their business and which associated metrics to report). In contrast, the GRI, whose framework covers topics such as labor and human rights issues, effects on biodiversity, and energy use and reduction, assesses materiality based on *impacts made by issuers* on the economy, environment and society.

Since various standards cover overlapping ESG topics but outline disparate disclosure requirements, there has been an ongoing effort to align across standards with respect to specific categories of ESG disclosures. For example, in terms of climate-related disclosures, the Corporate Reporting Dialogue ("CRD"), a platform convened by the International Integrated Reporting Council, has since November 2018 been working on its "Better Alignment Project" to assess alignment on the disclosure principles of the TCFD among its participant standard-makers, such as SASB, GRI, CDP (formerly the Carbon Disclosure Project), the Climate Disclosure Standards Board ("CDSB") and the International Integrated Reporting Council ("IIRC"). In a 2019 report of the Better Alignment Project, the CRD notes the challenges faced by both issuers producing ESG reports and users of ESG information due to disparities in the various standards and the need for greater harmony among frameworks. That report outlines commonalities and differences with respect to TCFD recommendations among various frameworks and standards developed by its participants, which is intended to assist companies in understanding and implementing those recommendations. The CRD's report states that many participants believe a single standard on climate-related disclosures is needed and notes that the Better Alignment Project may not be able to resolve this particular issue due to, among other things, the cross-border applicability a unified standard would require. The World Economic Forum has also released a consultation draft report drawing on many existing standards, with the aim of providing issuers with a core set of material ESG metrics and suggested responsive disclosures.

INVESTOR RESPONSE

One key development in the U.S. is the trend of institutional investors, which collectively hold average stakes of more than 20% in S&P 500 companies, issuing their own guidelines in support of SASB or TCFD standards. For example:

- BlackRock has requested the companies in which they invest to, by year-end 2020, (1) publish disclosure in line with industry-specific SASB guidelines and (2) disclose climate-related risks in line with the TCFD's recommendations. BlackRock will deem a failure to comply to be a signal that the company is not adequately managing ESG risk.[5]
- In 2019, State Street launched its R-Factor score, an ESG evaluation system based on the SASB framework. State Street has indicated that, beginning in 2020, it will "take appropriate voting action against board members at companies in the S&P 500, FTSE 350, ASX 100, TOPIX 100, DAX 30 and CAC 40 indices that are laggards based on their R-Factor scores and that cannot articulate how they plan to improve their score."[6] State Street has also issued statements in support of the TCFD framework.
- Vanguard has publicly encouraged companies to use standardized frameworks and specifically notes the value of the SASB framework generally and the TCFD approach with respect to climate-related disclosures.[7]

Many other investors have endorsed the SASB and TCFD frameworks. A Morrow Sodali survey from March 2020 of institutional investors found that 81% of respondents recommend that issuers use the SASB framework to better communicate ESG information and 77% recommend the TCFD framework for disclosure of climate-related financial information.[8] In its 2018 Annual Report, SASB reported that its framework has now been embraced by money managers with more than $30 trillion of assets in the aggregate.[9] Other investors have emphasized the benefits of standardized reporting, including the California State Teachers' Retirement System, Government Pension Investment Fund and USS Investment Management Ltd, which specifically urged portfolio companies to enhance their ESG disclosures using frameworks such as the TCFD's in a joint statement.[10]

DISCLOSURE CONSIDERATIONS

Currently, the SEC's disclosure standard on ESG can be tracked to its 2010 guidance on climate-related disclosures.[11] In that interpretive release, the SEC reiterated its principles-based approach to disclosure requirements and reiterated the materiality standard it applies to mandated disclosures. That guidance does provide an indication of several climate-related topics, such as legislative and regulatory responses, business and market impacts, and physical effects of climate change that *may* be material to issuers depending on their business, but did not mandate disclosure on any of these topics.

The House of Representatives' Financial Services Committee approved a proposal to require ESG disclosures (including climate change risk factors) in July 2019, but it has not come to the floor of the House. Senator Elizabeth Warren introduced a version of this legislation in the Senate on July 10, 2019 and, in an April 28, 2020 letter, urged Chairman Clayton to consider its proposed requirements with a view toward changes to the SEC disclosure regime. On January 30, in connection with the issuance of the revised MD&A guidance, SEC Commissioner Allison Herren Lee lamented the SEC's inaction on the issue of requiring specific climate disclosures from issuers.[12] On May 14, 2020, a subcommittee of the SEC Investor Advisory Committee recommended that the SEC begin a process to update reporting requirements to include "material, decision-useful, ESG factors" and, while its recommendation did not endorse any framework, it did note the GRI, SASB and TCFD standards as useful for the SEC to consider.[13] The SEC has indicated that it is willing to continue discussions with market participants on the topic of ESG disclosure requirements, encouraging them to engage with the SEC, particularly by helping the SEC understand how they use ESG-related information to make investment decisions.

Considerations Regarding Voluntary Implementation of an ESG Disclosure Framework

Notwithstanding shareholder support of ESG disclosure standards or standardized ESG disclosure frameworks, an issuer will learn more about, and may have an opportunity to shape, its investors' specific expectations with respect to the company's ESG disclosures from direct engagement. In meetings with investors, an issuer may have the opportunity to discuss the factors underlying its approach to disclosing ESG metrics, such as the uncertainty presented by its operations, the varying circumstances in different jurisdictions where it operates, competitive sensitivities associated with types of disclosures and other issues that may present challenges to the issuer's implementation of a standardized ESG framework. Major investors have suggested that they may be willing to give issuers leeway depending on company-specific circumstances. For example, although BlackRock CEO Larry Fink encouraged the adoption of disclosures that are in line with the SASB and TCFD frameworks, his 2020 letter to CEOs also specified that companies may instead "disclose a similar set of data in a way that is relevant to [its] particular business."[14]

If an issuer is considering adopting a standardized ESG disclosure framework, it will also need to consider:

- ***Feasibility of implementing adequate internal controls over ESG disclosures.*** With the heightened focus on ESG disclosure related to COVID-19, and if more companies begin to adopt standardized ESG disclosures that use data-based metrics (such as those required by SASB and TCFD), it is likely that plaintiffs' firms will increase their scrutiny of issuers' ESG disclosures. Notwithstanding whether there is legal liability associated with an issuer's ESG disclosure, there are likely to be reputational consequences for any material inaccuracies or failures to comply with the issuer's publicly stated ESG commitments. Issuers choosing to provide ESG disclosures should therefore carefully consider what is feasible and ensure they are able to meet the standards and commitments they adopt. Therefore, issuers considering adopting an ESG disclosure framework, whatever the format, should ensure that its ESG disclosure is subject to robust controls and procedures, as with any U.S. public disclosure.

- ***Primary intended audience and choice of framework.*** SASB- and TCFD-aligned disclosures are intended to be included alongside financial disclosures that are primarily intended to guide investment decisions by securityholders. Other frameworks may be more appropriate for disclosures that are intended for other stakeholder audiences. For example, the GRI's framework focuses on providing guidance specifically for sustainability reports.
- ***Location of the ESG disclosure (e.g., SEC filings, sustainability reports, company website).*** The location of any ESG disclosure provided by an issuer may impact the liability exposure associated with the disclosure. As with other types of public disclosures, ESG-related disclosures in SEC filings (other than those that are clearly identified forward-looking statements that are subject to the safe harbor under the Private Securities Litigation Reform Act) may result in liability under U.S. federal securities laws to the extent they are materially inaccurate or misleading.

Other Sources of ESG Disclosure Requirements

U.S. companies with international operations may be subject to jurisdiction-specific ESG disclosure requirements, such as the EU Regulation on the establishment of a framework to facilitate sustainable investment and the EU Regulation on sustainability-related disclosures in the financial services sector, which may apply to companies doing business within their territory regardless of the jurisdiction of organization or tax domicile of the company.

Likewise, companies may be subject to ESG reporting requirements under some material contracts. For example, sustainability-linked loans and bonds require borrowers and issuers, respectively, to measure and report on certain agreed ESG performance metrics that determine, in part, the interest payable under the loan or bond. In some instances, these metrics are based on standards developed by entities associated with rating agencies. Major rating agencies also now incorporate ESG factors in their ratings reports (for example, Moody's and S&P are both supporters of SASB and TCFD), and issuers therefore should consider ESG issues in their engagement with their rating agencies.

In addition, various investors have established funds dedicated to ESG-focused investment theses. The presence of such an investor among an issuer's shareholders may impact that issuer's approach to ESG disclosure and engagement. Some ESG-linked indices (such as the Dow Jones Sustainability Indices) and exchange traded funds also have their own metrics and standards for inclusion, and issuers should consider whether inclusion in these indices or fund portfolios is desirable. If ESG-focused funds continue to attract capital at growing rates, issuers may face more pressure to adapt their disclosures accordingly.

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ENDNOTES

1 According to the Governance & Accountability Institute, in 2018, 86% of S&P 500 companies published ESG or sustainability reports.

2 Comm'n Guidance Regarding Disclosure Related to Climate Change, Release No. FR-82, Release No. 33-9106, Release No. 34-61469 (Feb. 2, 2010).

3 JAY CLAYTON, PROPOSED AMENDMENTS TO MODERNIZE AND ENHANCE FINANCIAL DISCLOSURES; OTHER ONGOING DISCLOSURE MODERNIZATION INITIATIVES; IMPACT OF THE CORONAVIRUS; ENVIRONMENTAL AND CLIMATE-RELATED DISCLOSURE (Jan. 30, 2020).

4 *See* BLACKROCK, TOWARDS A COMMON LANGUAGE FOR SUSTAINABLE INVESTING, 8 (2020); STATE STREET, CEO'S LETTER ON OUR 2020 PROXY VOTING AGENDA (2020); STATE STREET, STATE STREET JOINS GLOBAL LEADERS TO ADDRESS CLIMATE CHANGE RISK AT VATICAN GATHERING (2019); VANGUARD, INVESTMENT STEWARDSHIP 2019 ANNUAL REPORT, 23 (2019).

5 BLACKROCK, *supra* note 4.

6 STATE STREET, CEO'S LETTER ON OUR 2020 PROXY VOTING AGENDA (2020).

7 VANGUARD, *supra* note 4.

8 MORROW SODALI, INSTITUTIONAL INVESTOR SURVEY 2020, at 4 (2020).

9 SUSTAINABILITY ACCOUNTING STANDARDS BOARD, ANNUAL REPORT 2018, at 7 (2019).

10 CAL. STATE TEACHERS' RET. SYS., GOV'T PENSION INV. FUND, USS INV. MGMT. LTD, JOINT STATEMENT ON THE IMPORTANCE OF LONG-TERM, SUSTAINABLE GROWTH (Mar. 5, 2020).

11 *See* Comm'n Guidance Regarding Disclosure Related to Climate Change, *supra* note 2.

12 ALLISON HERREN LEE, "MODERNIZING" REGULATION S-K: IGNORING THE ELEPHANT IN THE ROOM (Jan. 30, 2020).

13 SEC INVESTOR ADVISORY COMMITTEE, RECOMMENDATION FROM THE INVESTOR-AS-OWNER SUBCOMMITTEE OF THE SEC INVESTOR ADVISORY COMMITTEE RELATING TO ESG DISCLOSURE (May 14, 2020).

14 LARRY FINK, A FUNDAMENTAL RESHAPING OF FINANCE (Jan. 14, 2020).

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