

Climate Change, ESG, and Materiality

Climate change and ESG are topics that have been repeatedly addressed by regulators around the world. The Securities and Futures Commission of Hong Kong and the Monetary Authority of Singapore, for example, have repeatedly addressed the topics. Likewise, various members of the SEC have discussed the questions in public remarks. And, while serving as Acting Chair, Commissioner Allison Herren Lee directed the staff to work on the issues.

There is also no doubt that many U.S. public companies evaluate the issues as they formulate strategy and guide their enterprises into the future. Yet the Commission's disclosure standards in the area are over a decade old. Much has happened since then; but little has changed in the area for the Commission.

Recently, Commissioner Allison Herren Lee weighed in again, discussing four key myths about climate change in remarks delivered at the *2021 ESG Disclosure Priorities Event* on May 24, 2021. Myth 1 is that "ESG matters . . . material to investors are already required to be disclosure . . ." Incorrect. Materiality standing alone does not impose a disclosure obligation. To the contrary, absent a specific duty to disclose, materiality does not require disclosure as the Supreme Court has repeatedly held in cases such as *Basic v. Levinson*, 485 U.S. 224 (1988).

Myth 2, is a bit trickier, according to the Commissioner. This myth states that "where there is a duty to disclose climate and ESG matters, we can rest assured that such disclosures are being made." Incorrect. Materiality is an objective, reasonable investor standard, the Commissioner notes. Nevertheless, materiality is all too often in the eye of the beholder. What one person sees as material another does not. Enforcement cases brought by the agency chronicle numerous examples where matters that one group may view as "material" under the objective reasonable investor standard, another does not. Accordingly, even if there are disclosure obligations under the federal securities laws, that does not necessarily mean that business enterprises are making the disclosures.

Related Capabilities

- Securities & Financial Services Litigation & Enforcement
- Environmental, Social, Governance (ESG)

The third myth is that “SEC disclosure requirements must be strictly limited to material information.” Incorrect again. While it is true that the antifraud provisions such as Exchange Act Section 10(b) and Securities Act Section 17(a) are grounded on materiality, others are not. For example, the Commission’s rule writing authority under Securities Act Section 7 does not have a materiality requirement. The same thing can be said about Exchange Act Sections 12,13 and 15. Likewise, Regulation S-K frequently requires disclosures without citing a materiality standard.

The final myth states that “climate and ESG are matters of social or ‘political’ concern, and not material to investment or voting decisions.” Incorrect. The issues here are tied to science, and while they may have some social or political implications, that does not translate them into matters that are not material to investors. As the Commissioner notes, the ultimate decision on materiality rests with investors. There is no doubt that many view the questions as important and critical. In the end, the debate on climate and ESG should not be guided by incorrect myths.

Comment

No doubt the Commissioner is correct that the debate over climate and ESG should not be mired in false myths. Nor should it be lost under labels like “political” or “social.” The questions are far too important for such an approach. One need only look to the actions of other regulators around the world who are discussing the issues and implementing appropriate standards to grasp the point.

The question for the Commission in the first instance, however, should not hinge on selecting which standards or program or other construct to adopt. The question is how are public enterprises using shareholder money in the areas of climate change and ESG? How do corporate executives deploy the resources of the company in these areas? Or do those managers refuse to allocate any resources on the question of climate change and ESG?

Each of these questions, and a host of others, are being addressed by issuers that are deploying shareholder resources on the issues. Shareholders are entitled to know how the resources of the enterprise are being used – those resources, after all, are being paid for with shareholder money. The MD&A, for example, is a section which is supposed to put the shareholder in the seat of the CEO and show that shareholder how the enterprise is being shepherded today, tomorrow and the day after that with the shareholders’ money. Whatever one believes materiality means, there is no doubt that it requires shareholders be told how their money is being spent.