WITNESSING AN EVOLUTION: INVESTORS DRIVING DEMAND FOR

SUSTAINABILITY DISCLOSURE

A former SEC chair urges IR professionals to help their companies provide better sustainability disclosure to investors.

BY ELISSE WALTER

During the more than two decades of my career at the U.S. Securities and Exchange Commission (SEC) – as a staffer, commissioner, and chair – I spent each day focused on one question: how do we help investors?

During that time, I witnessed a profound transformation in the information investors need to make decisions in today's world. These changing information needs reflect a changing globe: sustainability issues such as climate change, resource constraints, and data security are increasingly affecting the way companies operate. As such, mainstream investors want to know how companies are performing on material sustainability risks and opportunities.

This was not the case when I started at the SEC in 1977. Several years prior, in 1971, the National Resources Defense Council (NRDC) brought a rulemaking petition to the SEC seeking to expand civil rights and environmental disclosure under the securities laws.

At that time, the SEC rejected calls for increased requirements for such disclosures largely due to a lack of sufficient investor interest: the percentage of holdings of "ethical investors" was estimated at "two thirds of one percent" of all U.S. stock and bonds.

When examined in the light of proxy voting, the SEC found that proposals around social issues received a paltry average of 2-3 percent of affirmative votes. So the Commission determined these disclosures were of interest to only "an insignificant percentage" of investors. Moreover, while the SEC acknowledged its broad powers under the Exchange Act, it concluded that it didn't have the authority to require disclosure of information that was primarily valuable in a social context.

That last part remains true today: securities laws exist to serve investors, not serve a social purpose. But what has changed is that sustainability factors increasingly impact the financial condition and operating performance of companies. As such, these factors have a heightened potential to be material to investment decisions. Mainstream investors want to incorporate sustainability factors into their investment decisions. This is no longer a niche activity.

Dubious? Let me give you a few stats. 89 percent of the world's top 100 asset managers are signatories to the Principles for Responsible Investment (PRI), including BlackRock, Vanguard, SSGA, Fidelity Investments, JP Morgan, and PIMCO. Signatories commit to incorporating environmental, social, and governance (ESG) issues into investment analysis and decision-making processes and seek appropriate ESG disclosure by the entities in which they invest.

As BlackRock CEO Larry Fink, head of the world's largest investment management corporation, observed in his 2016 letter to companies, "Generating sustainable long-term returns for our clients also requires us to factor the ESG challenges companies face today, such as climate or changing labor markets, into our investment analysis and decision-making processes."

The SEC, too, has acknowledged burgeoning investor interest in sustainability disclosure. In April 2016, the SEC issued a concept release on Regulation S-K that invited feedback on a range of issues related to how disclosure must evolve to meet the needs of today's investors, including the topic of sustainability disclosure. Although just 3 percent of the concept release discussed sustainability, 66 percent of the non-form letters discussed sustainability disclosure, and 85 percent of sustainability-related letters called for improved disclosure of sustainability factors in SEC filings. Demand by investors for better sustainability information – because they deem it material to investor decisions – is clear.

Yet, there's a disconnect between investor demand for improved ESG disclosure and corporate response to this demand. In a 2016 PwC survey, 100 percent of corporate respondents expressed confidence in the quality of ESG information they report, but only 29 percent of investors said they are confident in the quality of the ESG information they receive.

Because of the lack of decision-useful information in existing sustainability disclosures, investors resort to other means of getting data and assessing performance. The number of sustainability-related shareholder proposals filed each year continues to rise. In 2016, 67 percent of resolutions filed related to ESG issues, according to Proxy Preview data. And, it's not uncommon for companies to receive hundreds of ESG questionnaires every year, which are costly and time-intensive to respond to.

A Role for IR Professionals

That's where IR professionals come in. More complete corporate disclosure is an opportunity to better communicate your story. And by disclosure, I mean the information investors need to put the numbers into context – not just the "what?" and "how much?" but the "why?" That's where sustainability disclosure – which often deals with forward-looking information – comes in.

The principal section to do this is in the Management's Discussion and Analysis, or MD&A. This section was first introduced in 1968, and the SEC adopted the current framework for MD&A in 1980. For 35-plus years, companies have been using this section of their statutory filings to explain financial statements from management's perspective, to enhance financial disclosure and provide context for its analysis, and to enable investors to better understand whether past performance is indicative of future results.

MD&A, Item 303 of Regulation S-K, already requires that companies describe known trends, events, and uncertainties that are reasonably likely to have material impacts on their financial condition or operating performance in the MD&A section of Form 10-K or 20-F. As such, companies often address sustainability matters in SEC filings.

According to 2016 research by the Sustainability Accounting Standards Board (SASB), 69 percent of companies are already addressing at least three-quarters of SASB disclosure topics for their industry, and 38 percent are already providing disclosure on all SASB disclosure topics.

When companies address these issues in their Form 10-K or 20-F, it is a clear indication that they consider the risk to be material and the information to be relevant to investors. However, more than half of sustainability-related disclosures in SEC filings use boilerplate language, which is inadequate for investment decision-making.

This is where corporate disclosure currently falls short of investor expectations, because boilerplate disclosure isn't effective. All companies – even all companies within a single industry – are not the same. For example, they are not affected in the same way by external trends and uncertainties. SEC regulations set the stage, telling companies what, at a minimum, should be covered, but it's up to the company to make sure the story gets told. That's where MD&A becomes a real opportunity for the company to tell shareholders what's really going on.

In my view, companies should address investors like they are business partners, and the MD&A should reflect that perspective. You wouldn't address a business partner with boilerplate. Your investors deserve the same respect. They also deserve the whole story.

To tell the whole story, it's important to put yourself in the perspective of the investor; to ask yourself, "What do investors want to know?" Disclosure isn't driven by what the company wants to disclose but by what the investors want to know. That should be front-and-center as you draft and review the MD&A.

Sometimes finding the right details to give investors is hard. Predicting the impact, either positive or negative, of a future event is even more challenging. It requires significant judgment and thoughtful consideration. But it's a task that should be undertaken by the very insiders who have the information to make that call, so that investors have the complete story. The focus should always be on the investors. SASB standards are a resource to help companies give investors the sustainability disclosure that is material to the companies to which they entrust their resources.

Benefits of Better Disclosure

More complete disclosure will have benefits. Full disclosure is a hallmark of good corporate governance, which should help create the positive corporate culture that results in effective processes and procedures necessary to reveal the important information that your investors need to know. You can only succeed at good governance if you succeed at disclosure.

As discussed, today's investors are interested in material sustainability information. Given the lackluster quality of sustainability disclosure currently finding its way into SEC filings, what we have is a failure to communicate. This is a missed opportunity. Studies have shown a correlation between high-quality investor relations, which naturally involves effective communication, and increased market valuation and lowered cost of capital.

So how should companies proceed to respond to increased investor pressure for more effective sustainability disclosure?

Let's be clear: the regulation to provide this information already exists. Regulation S-K, which is focused on delivering full, accurate, and intelligible information to investors, already provides for the disclosure of information on sustainability factors when they are reasonably likely to have material impacts on a company's business.

How to Meet Changing Investor Need

To reiterate, the information needs of investors are changing. Investors, in fact, have been the driving force behind the development of much of our financial reporting infrastructure. When the Securities Act was passed in 1933, and the Securities Exchange Act in 1934, investor protection was the primary objective and disclosure was the primary tool they used to achieve it.

The reforms of corporate disclosure practices that occurred during the Great Depression – including those that began as voluntary efforts – are analogous to what is happening now with the emergence and evolution of sustainability disclosure. The core principles that guided that reform – such as the importance of transparency, the primacy of investor protection, and the use of materiality as a moderator – are still relevant today.

Just as the needs of investors once precipitated the establishment of the federal securities laws, of GAAP, and of auditing standards, those needs today must fuel our efforts to bring disclosure into the 21st century.

It is somewhat understandable that many companies are choosing to respond to the regulation with boilerplate. Until recently, companies have referred to U.S. Generally Accepted Accounting Principles (GAAP) for the disclosure of material financial information, but have lacked access to standards for the disclosure of material sustainability information.

This has changed: SASB has prepared standards that help public corporations disclose material information to investors in SEC filings in a cost-effective and decision-useful manner. SASB maintains standards for 79 industries, focusing on sustainability factors that are reasonably likely to have financially material impacts. SASB is becoming the market standard for the disclosure of material sustainability information to investors.

During my decades as a regulator, it was my job each day to help the SEC fulfill its mission to help investors. Effective corporate disclosure is critical to maintaining and improving investor confidence in the markets. And investor confidence in the quality of financial disclosures is what makes our markets work. Better disclosure equals better markets.

Investor demand for sustainability information has reached a critical mass. Simply put, sustainability issues are business issues. They can have material impacts on the financial condition or operating performance of a company, or an entire industry. The time has come for companies to respond. IR professionals should view disclosure not as an obligation, but as a chance to better tell your company's story. IR

ELISSE WALTER served as a commissioner at the SEC from 2008 to 2013 and was chair from December 2012 through April 2013. She now is a member of the SASB Foundation Board of Directors and spoke during a general session at the NIRI 2017 Annual Conference.