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SEC INVESTOR ADVISORY COMMITTEE

Panel on Sustainability Reporting

10:30 AM – 12 Noon
July 14, 2016

Opening Remarks of Daniel L Goelzer
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Good morning. I appreciate the opportunity to meet with the Committee to discuss the important subject of sustainability reporting under the federal securities laws.

I was asked to provide an overview of the Commission's traditional approach to pubic company reporting of information relating to corporate social responsibility, environmental impact, and other matters that fall under the broad heading of sustainability or ESG.[1] I will also offer a few comments on how, in my view, the Commission should approach these issues today.

The Basic SEC Framework

The framework that the Commission has traditionally applied to ESG reporting was established in the 1970s, in response to rulemaking petitions and litigation seeking to compel the Commission to adopt environmental and equal employment disclosure requirements. As a personal aside, when I arrived in the General Counsel's office as a new staff attorney in 1974, I was assigned to that litigation – NRDC v. SEC[2] – and it was one of the main things I worked on during my first years at the Commission.

To comply with one of the court's orders in the litigation, the Commission invited comment and held 19 days of public hearings on disclosure of environmental and socially significant matters. Following those proceedings, the Commission issued a release[3] in 1975 that reached four basic conclusions --

- First, in formulating disclosure policy, the Commission is generally not authorized to consider the promotion of social goals unrelated to the objectives of the federal securities laws. Disclosure requirements must be necessary or appropriate to protecting investors or to informing their investment or proxy voting decisions.

- Second, the Commission's disclosure authority should be exercised to require information based on its economic significance to investors. The Commission recognized however that, in the area of proxy disclosure, "the primacy of economic matters * * * is somewhat less."[4]

- Third, looking at the markets in 1975, the Commission concluded that only a very small fraction of investors were motived by social responsibility considerations. Accordingly, the Commission found that there was no basis to require public companies to disclose information describing corporate social practices.

- Fourth, even without specific disclosure requirements, ESG disclosures may sometimes be necessary to prevent other statements from being materially incomplete or misleading. In this regard, in 1976, the Supreme Court held that an omitted fact is material 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 available."[5] Stated differently, a fact is material if there is a substantial likelihood that it would be significant to a reasonable investor's investment or proxy voting decisions.

The Commission also acknowledged that Congress could expand its disclosure responsibilities. It concluded that the National Environmental Policy Act was such an expansion in the sense that it required the Commission to consider environmental protection as a factor in disclosure.[6] As a result, the Commission adopted two rules.

- First, as part of the description of the business, companies must describe the material effects that compliance with environmental protection laws may have on capital expenditures, earnings and competitive position and on estimated expenditures for environmental control facilities.[7]

- Second, with respect to legal proceedings against the company, the Commission set a lower threshold for disclosure of environmental litigation than for other types of cases.[8]

Consistent with these mid-1970s determinations, the Commission did not adopt any further rules requiring disclosure of ESG matters until, in 2010, Congress directed it to do so in some specific areas.[9]

However, since 1975, two important changes have occurred in the disclosure requirements which <u>do</u> potentially call for some types of sustainability disclosures.

- Item 303 of Regulation S-K – Management's Discussion and Analysis – seeks to provide investors with a view of the company's financial condition and results of operations "through the eyes of management." As relevant to sustainability disclosures, Item 303 requires disclosure of known trends, events, and uncertainties that are reasonably likely to have material effects on the company's business, financial position or results of operations.[10]

- Item 503(c) of Regulation S-K -- Risk Factors — requires a discussion of the most significant factors that make an investment in the company speculative or risky and an explanation of the effects of those risks.

Both of these requirements are inherently forward-looking, or predictive and potentially implicate some of the concerns that sustainability reporting seeks to address. However, the level of sustainability disclosures in MD&A and Risk Factors is, in practice, limited and usually quite general.

Financial Statement Disclosure – The FASB

Another piece of the traditional approach to sustainability reporting is financial statement disclosure. The Financial Accounting Standards Board promulgates the accounting principles under which financial statements filed with the Commission must be prepared. Accounting Standards Codification Topic 450 deals with loss contingencies – that is, possible losses that depend on whether some future event occurs or fails to occur. Losses resulting from pending litigation and from environmental remediation obligations are examples of loss contingencies.

ASC 450 requires disclosure of contingencies based on the likelihood that the uncertain event will occur and result in a material loss.

- If the uncertain event is "remote" (that is, the chance of its occurring is slight), the contingency need not be disclosed.
- However, if the occurrence of the future event is either "probable" or "reasonable possible", the contingency must be disclosed in the footnotes to the financial statements and, in some cases, the loss must be accrued.

Several years ago, the FASB explored requiring disclosure of remote contingencies that would have a severe impact on the company (for example, disrupt normal functioning of the business).[11] However, the Board withdrew that proposal in 2012.

Recent History

That completes my overview of the traditional approach to sustainability reporting.[12] There have, however, been several more recent developments that are also relevant.

First, in 2010, the Commission issued an interpretive release providing guidance on how the existing disclosure requirements apply to climate change matters.[13] The release discusses topics such as the legislation and regulation, business and market impacts, and physical impacts. It also provides examples of circumstances in which companies could be required to disclose information concerning the consequences of climate change-related matters for their business.

Second, Congress has directed the Commission to adopt several ESG-related disclosure requirements. I would put in that category the Dodd-Frank Act provisions regarding conflict minerals, resource extraction payments, mine safety, and CEO/median employee pay-ratios.[14]

Finally , public company voluntary sustainability reporting has become common. These reports typically appear on corporate websites and are not filed with the

Commission. They are often aimed at broader audiences than investors – such as customers, employees, local communities, and others with an interest in the environmental or social impact of the company's operations. The processes underlying data collection and preparation of these voluntary reports are often less rigorous than those that apply to SEC reporting. Also, there is no consistency across companies or industries as to what is disclosed.

Suggestions for the Way Forward

I would like to close with some suggestions about how the Commission should approach ESG disclosure.

First, in my view, the underlying principles of the traditional disclosure approach remain valid. The Commission's focus should be on requiring disclosures that are relevant to investment or proxy voting decisions, not other policy goals. As a corollary, the Commission should retain the existing definition of materiality, which looks to significance to the reasonable investor.

Second, the Commission's disclosure system needs to take into account the fact that today investors can and do use of sustainability information in economically-based investment decision-making. Unlike the small percentage of investors that used ESG information in 1975, there is growing demand for this information – not because investors are necessarily more socially conscious – but because many believe that ESG disclosures are relevant to their assessment of the long-term profitably and viability of the businesses in which they invest.

Third, the Commission's approach to sustainability reporting should be primarily principles-based, rather than prescriptive. Sustainability issues affect different companies and different industries in different ways. Across-the-board disclosure rules are likely to be either under- or over-inclusive and difficult to justify on a cost-benefit basis.

Finally, the Commission should look for ways to leverage non-governmental efforts to create disclosure frameworks that provide decision-useful information to investors. For example, the Sustainability Accounting Standards Board is developing industry-specific disclosure standards that are intended to dove-tail with the Commission's existing requirements, particularly MD&A. Over time, I think there is great potential for this sort of approach to result in an industry-by-industry consensus about the type of sustainability information that companies should disclose, without the need for the Commission itself to grapple with these issues by developing detailed guidance or writing new disclosure rules.

* * *

Thank you for your attention. I look forward to discussing these issues with the Committee.

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Endnotes:

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[1] "ESG" – which stands for "environmental, social, and governance" -- is often used as a shorthand way of referring generally to a broad range of factors that are relevant to evaluating corporate responsibility and long-term sustainability.

[2] The Court of Appeals decision that finally ended this litigation is Natural Resources Defense Council, Inc. v. Securities and Exchange Commission, 606 F.2d 1031 (D.C. Cir. 1979). The lower court opinions are reported at 389 F. Supp. 689 (D.D.C. 1974) (NRDC I) and 432 F. Supp. 1190 (D.D.C. 1977) (NRDC II).

[3] Securities Act Releases No. 5627 (Oct. 16, 1975), 40 Fed. Reg. 51656 (1975). See also Securities Act Release No. 5704 (May 6, 1976), 41 Fed. Reg. 21632 (1976).

[4] Release No. 5627, supra note 3, 40 Fed. Reg. at 51659.

[5] TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976).

[6] Release No. 5627, supra note 3, 40 Fed. Reg. at 51662.

[7] Item 101(c)(1)(xii) of Regulation S-K. Item 101(c)(1)(xii) requires companies to disclose, as part of the Description of Business, "the material effects that compliance with federal, state and local provisions which have been enacted or adopted regulation the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position" of the company and its subsidiaries; and "any material estimated capital expenditures for environmental control facilities for the remainder of [the company's] current fiscal year and its succeeding fiscal year and for such further periods as the [company] may deem material."

[8] Item 103 of Regulation S-K requires generally companies disclose material pending or contemplated legal proceedings, "other than ordinary routine

litigation incidental to the business." Instruction 5 provides that litigation arising under environmental laws may not be deemed ordinary routine litigation incidental to the business, and must be disclosed, if (1) the litigation is material; (2) the litigation involves more than 10 percent of current assets, or (3) a government agency is a party to the litigation, unless the company reasonably believes any sanctions will be less than $100,000.

[9] See note 14, infra.

[10] Item 303 generally requires a company to disclose "material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. The disclosure focuses "on currently known trends, events, and uncertainties that are reasonably expected to have material effects" on the company's business, financial position or results of operations.

[11] See Financial Accounting Standards Board, Exposure Draft, Proposed Accounting Standards Update, Contingencies (Topic 450), Disclosure of Certain Loss Contingencies (July 20, 2010).

[12] It should be noted that there have been a limited number of environmental disclosure enforcement actions based the framework. For example –

- Allied Chemical. In 1977, the Commission brought an enforcement action against Allied Chemical Corporation alleging that Allied violated Rule 10b-5 by failing to disclose potential environmental liabilities which could result from the discharge of Kepone and other toxic chemicals. No claims had been asserted, but the company allegedly knew that Kepone was harmful and could lead to liability. See Litigation Release No. 7811 (1977).
- United States Steel Corporation. In 1979, the Commission brought an enforcement action against United States Steel Corporation. This case is somewhat unique in that the Commission alleged that USS should have disclosed its policy of "actively resisting environmental requirements which it maintained were unreasonable." This policy alleged resulted in delaying necessary environmental capital expenditures. See Securities Exchange Act Release No. 16223 (1979).
- Occidental Petroleum. In 1980, the Commission brought an enforcement action against Occidental Petroleum Corporation alleging that it had failed to disclose in its filings potential liabilities arising from the discharge of toxic waste by a subsidiary, Hooker Chemical, including at the notorious Love Canal disposal site. See Securities Exchange Act Release No. 16950 (1980).

- Lee Pharmaceuticals. In 1998, the Commission brought an enforcement action against Lee Pharmaceuticals alleging that Lee violated Rule 10b-5 by misrepresenting and failing to disclose a material environmental liability. See Securities Exchange Act Release No. 39843 (1998).

[13] Commission Guidance Regarding Disclosure Related to Climate Change, Securities Act Release No. 9106 (February 2, 2010).

[14] Section 1502 of the Dodd-Frank Act adds Section 13(p) to the Securities Exchange Act. Section 13(p) directs the SEC to adopt rules requiring public companies to disclose whether certain “conflict minerals” originating in the Democratic Republic of the Congo and adjoining areas are necessary to the functionality or production of a product manufactured by the company. The specific minerals consist of cassiterite, columbite-tantalite, wolframite, their derivatives (tin, tantalum and tungsten), and gold. Under the Commission’s implementing rules, conflict minerals disclosure is required to be made on a new report, Form SD. Where the company determines that its products contain, or may contain, conflict minerals originating from the DRC or its neighbors, it must also file a conflict minerals report as an exhibit to Form SD. Some aspects of a conflict minerals report are subject to an independent audit requirement..

Section 1504 of the Dodd-Frank Act adds Section 13(q) to the Securities Exchange Act. Section 13(q) directs the SEC to require certain disclosures from “resource extraction issuers,” which are companies required to file an annual report with the SEC under the Exchange Act that are engaged in the “commercial development of oil, natural gas and minerals.” The Commission’s implementing rules require resource extraction issuers to disclose certain payments made (either directly by the issuer or through a subsidiary or other controlled entity), during the fiscal year covered by the report, to a foreign government or to the U.S. federal government for the purpose of the commercial development of oil, natural gas, or minerals.

Under Section 1503 of the Dodd-Frank Act, mining companies are required to include certain specified information about mine safety and health in quarterly and annual reports filed with the SEC. In addition, mining companies are required to file a Form 8-K when they receive certain notices from the Mine Safety and Health Administration. Section 1503 applies to a public company that is “an operator, or that has a subsidiary that is an operator, of a coal or other mine.”

Section 953(b) of the Dodd-Frank Act requires the SEC to amend Item 402 of Regulation S-K to require that companies disclose the median of the annual total compensation of all employees (except the CEO), the annual total compensation of the CEO and the ratio of the median of the annual total compensation of all employees to the annual total compensation of the CEO.