SUSTAINABILITY DISCLOSURE IN PUBLIC COMPANY ANNUAL REPORTS AND PROXY STATEMENTS—STATE OF PLAY AND THE FUTURE

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Introduction

Public interest groups and socially responsive investors have been for decades pushing for increased sustainability (also known as environmental, social, and governance or ESG) disclosure by public companies. Surprisingly, many mainstream investors (in the United States and worldwide) are now joining the call for better and more uniform sustainability disclosure, arguing that such disclosure is required for them to be able to make informed investment decisions. Some global stock exchanges have also thrown their support behind this campaign and the U.S. Securities and Exchange Commission (SEC) appears to be listening, too.

Shareholder activism, specifically submitting shareholder proposals to U.S. public companies for inclusion in such companies' annual proxy statements on form DEF 14A was one of the original tools of public interest groups to compel companies to disclose and consider sustainability matters. This strategy had manifold benefits to the public interest groups, including forcing companies to focus on their sustainability issues, generating helpful written statements from the SEC in response to company no-further action letter requests to exclude these proposals from their proxies, and gaining media attention for the cause. This activism proved to be a fertile training ground for the interest groups who continue to submit various sustainability shareholder proposals, but are now focusing their sights on the next frontier, i.e., *binding* sustainability disclosure requirements.

This article discusses the key binding ESG disclosure frameworks currently being proposed, the groups behind them, and why they should be of interest to all public companies and those who advise them. The article then discusses some noteworthy sustainability shareholder proposals submitted in the 2012 and 2013 proxy seasons and some important SEC decisions made in connection therewith.

Global ESG Disclosure Initiatives

Various ESG interest groups, such as the newly formed Sustainability Accounting Standards Board (SASB), as well as the Investor Network on Climate Risk (INCR), an affiliate of Ceres, a long-standing leader in sustainability issues, have been working in parallel with regulators to adopt binding standards by which publicly traded companies would be required to disclose their ESG issues. ESG issues include (1) environmental issues (such as climate change and natural resource scarcity issues); (2) social issues (such as human rights, diversity, and stakeholder relationship issues); and (3) governance issues (such as management structure and executive compensation). As stated by the California Public Employees Retirement System (CalPERS), the largest public pension fund in the United States with approximately $261 billion in assets and a standards council member of SASB, if CalPERS were to close its doors today, it would still be required to make payments for the next 80 years, and investments in companies that focus solely on short-term profits may not do the trick. Seen in this light, ESG disclosure has as much to do with economic sustainability as it does with environmental or social sustainability. Importantly, Meyer "Sandy" Frucher, the vice chairman of the NASDAQ OMX Group (NASDAQ OMX), stated publicly in April 2013 that "nonfinancial [ESG disclosure] is essential for investors to make a decision" and that there is a need for a "uniform standard." He noted that the New York Stock Exchange has joined NASDAQ OMX in this goal and together will advance ESG disclosure requirements before the World Federation of Exchanges in October 2013. In addition, companies like Bloomberg have begun to publish corporate ESG data for over 5000 companies, with more than 120 ESG indicators on display.

INCR

In April 2013, the INCR Listing Standards Drafting Committee released its consultation paper titled "Proposed Sustainability Disclosure Listing Standard

NASDAQ OMX, among other exchanges, has publicly expressed support for INCR's initiative and, according to INCR, this consultation paper is in response to such exchange interest, and aims to develop "a unified sustainability disclosure listing standard that could be adopted by all stock exchanges," as a prerequisite to being listed. The consultation paper's main requirement is for all listed companies to disclose sustainability risks pursuant to the Global Reporting Initiative (known as GRI). GRI, as most readers are aware, would require significant disclosure of sustainability issues above and beyond what is ordinarily deemed material under U.S. securities law. While ambitious, it is unlikely that NASDAQ OMX will adopt these standards unless its competitor exchanges do so, to avoid "forum shopping" by public companies. The consultation paper's public comment period ended on May 1, 2013.

INCR's Listing Standards Drafting Committee includes such prominent entities as Rockefeller & Co, BlackRock, AFL-CIO Office of Investment, as well as ESG institutional investors such as Boston Common Asset Management (see "ESG Proxy Matters," below) and Domini Social Investments (which readers may recall as being one of the entities, with Ceres, strategic in convincing the SEC to adopt its February 2010 "Commission Guidance Regarding Disclosure Related to Climate Change").

SASB

Relatedly, but in contrast, SASB (which despite its name is not affiliated with the Financial Accounting Standards Board (FASB) or the International Accounting Standards Board (IASB)) is also creating and disseminating sustainability accounting standards pursuant to which U.S. public companies and foreign private issuers must disclose "material" (as defined by the U.S. securities laws) sustainability issues in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) sections of their annual reports on forms 10-K and 20-F, respectively. Through this disclosure, SASB's goal is to enable peer-to-peer benchmarking of sustainability issues. A standards setting organization accredited by the American National Standards Institute, SASB meets with the SEC chairman as well as the director of the SEC's Division for Corporation Finance on a quarterly basis to brief the SEC on its progress. At one such meeting, the SEC apparently informed SASB that it would not consider a line item requirement for ESG disclosure because what may be "material" varies from sector to sector. As a result, SASB has begun drafting through multi-stakeholder industry working groups and expects to adopt, by the second quarter 2015, ESG disclosure standards for 88 different industries in the following ten sectors: (1) health care; (2) financials; (3) technology and communication; (4) non-renewable resources; (5) transportation; (6) services; (vii) resource transformation; (8) consumption; (9) renewable resources and alternative energy; and (10) infrastructure. Companies in these ten sectors are welcome (and may wish) to join SASB's industry working groups, other than the health care and financials working groups that are now closed, so that they can have a voice in the standards setting process.

Once released, SASB will request that the SEC adopt these standards, likely in the form of SEC interpretive guidance similar to the 2010 SEC climate change disclosure guidance referred to above. It should be noted that as the current SEC chair's term is set to expire in June 2014, it remains to be seen whether the then-SEC chair (which could continue to be Mary Jo White if Congress votes to extend her term as President Obama has requested) and the newly appointed director of the SEC's Division for Corporation Finance, Keith Higgins, will be amenable to adopting these various standards.

SASB is working with the Public Company Accounting Oversight Board to devise standards for external auditing or other assurance of sustainability disclosure so that this disclosure could ultimately appear and be audited as part of a company's audited financial statements (in addition to or ultimately in lieu of MD&A).

SASB, like the INCR, is backed by numerous high-profile individuals. Its advisory council is comprised of over 100 individuals affiliated with various banks, institutional investors, academics, public interest groups and other interested professionals, such as BlackRock, Deutsche Bank, Ernst & Young, Goldman Sachs, Institutional Shareholder Services (ISS), JP Morgan, Morgan Stanley, PwC, Robert Herz (former FASB chairman and former IASB board member), United Nations Principle for Responsible Investment (UNPRI), McKinsey, Domini Social Investments, Environmental Defense Fund, Ceres, and the Natural Resources Defense Council.

Other Initiatives

In addition to INCR and SASB's efforts, there are a number of other global ESG disclosure initiatives including:

- The CDP (formerly known as the Carbon Disclosure Project);
- Global Initiative for Sustainability Ratings;
- The International Integrated Reporting Council (IIRC);
- The Prince's Accounting for Sustainability Project (A4S);
- Project Delphi in Europe;
- United Nations Environment Programme Finance Initiative (UNEP FI); and
- United Nations Global Compact (UNGC) (via its Communication and its Progress reporting requirements).

These standards vary in focus and substance, but are further evidence of the growing interest in ESG disclosure (as well as the current lack of uniformity for the same).

ESG Proxy Matters

The public interest groups advocating for sustainability matters form a community with various, and sometimes dizzying, overlap and cross-pollination. Their grassroots efforts and ability to organize and share information can be best seen in their long-standing work in shareholder activism, particularly in requiring public companies to disclose in their annual proxy statements filed with the SEC ESG shareholder proposals. Their success has been so widespread that the respected ISS, a leading organization that provides assistance and research to institutional shareholders, has instructed shareholders generally to vote "for" greenhouse gas and climate change shareholder resolutions in its January 2013 U.S. Proxy Voting Summary Guidelines. Indeed, Ceres refers to these shareholder activists as their "investor network." Their success in sustainability shareholder proposals was quite likely the precursor to the above-described efforts for more formal and systematic disclosure requirements across the board.

Climate Change as a Significant Policy Issue

There were two recent ESG proposals worthy of discussion because of the SEC's response. First, arguably the most talked about sustainability proposal this proxy season was Boston Common Asset Management's proposal to PNC Financial Services Group Inc., a leading U.S. financial institution. The proposal would have required the bank's board of directors to report to shareholders on the bank's "assessment of greenhouse gas emissions resulting from its lending portfolio and its exposure to climate change risk in its lending, investing and financing activities." Boston Common, who submitted this proposal on behalf of itself and four other shareholders (including Domini Social Investments), collaborated with Ceres and others to submit this proposal. PNC appealed to the SEC for a no-further action letter to exclude such proposal from its 2013 proxy, but the SEC responded that "climate change is a significant policy issue" that required PNC to include the proposal in its proxy. PNC's annual meeting to vote on the proposal, held in late April 2013, ended after only 20 minutes due in part to the disturbance caused by Boston Common supporters in attendance. While the proposal failed to pass (garnering only 22.8 percent of the vote), financial institutions should be prepared to see the language of Boston Common's proposal be submitted, verbatim, during next year's proxy season.

Sustainability as a Significant Policy Issue

Calvert Investment Management and the Green Century Equity Fund, two well-known ESG shareholder proponents, submitted during the 2012 proxy season a sustainability proxy proposal to Cleco Corporation, a power services provider with holdings in fossil fuel-fired electric utilities. The proposal called for the company to issue a sustainability report including a comprehensive discussion of its sustainability risk and opportunities, as well as an sustainability risk and opportunities, as well as an analysis of material water-related risks. Cleco, like PNC, submitted a no-action letter request to the SEC, which request included detailed arguments as to why the proposal did not focus on a "significant policy issue" and thus could be excluded from its proxy statement. In January 2012, the SEC disagreed, affirmatively noting that the proposal "focuses on the significant policy issue of sustainability." The proposal just missed adoption, gaining 45.6 percent of the shareholder vote.

Conclusion

It is said that law reflects society's economic, moral, and social values. If so, we may well see binding ESG disclosure standards applicable to public companies in the not too distant future.

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