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# Heads Up for the 2018 10-K and Proxy Season: Spotlight on Corporate Sustainability

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Institutional investor calls for enhanced transparency regarding portfolio companies' identification and management of evolving sustainability risks gained considerable momentum over the past year, as reflected in shareholder voting patterns during the 2017 proxy season, developments in investor "stewardship" codes and a pronounced increase in "voluntary" corporate sustainability reporting. We expect this trend to continue, or even accelerate, during the 2018 season.

## What is Sustainability and How Much Does it Matter to Investors?

The term "sustainability" is generally understood to mean environmental, social and governance (ESG) issues that can affect investment and/or proxy voting decisions associated with corporate stock ownership. It includes a host of such diverse topics as climate change, labor relations, supply-chain human rights (e.g., use of slave labor by suppliers) and corporate political contributions and lobbying activities (to name just a few).

Long gone are the days where only a few "socially responsible" investors focused on sustainability issues – today, some of the country's largest asset managers (e.g., Vanguard, BlackRock Inc., Fidelity Investments, State Street Global Advisors) and public pension funds (CalPERS, CalSTRS, NYS funds) are publicly advocating greater corporate accountability in the ESG realm, perhaps most notably in the area of climate change. BlackRock, the world's largest asset manager, recently sent "open letters" to 120 companies in the energy, transportation and industrial sectors urging improved disclosure of "'material climate risk inherent in their business operations'" in accordance with the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD).[1] The CEO of Vanguard published a similar letter in August 2017.[2]

Many of these institutional investors literally are putting their money where their collective mouth is. More than 1,600 investors (together managing more than $70 trillion in assets) have committed to incorporating ESG factors into their portfolio asset management practices, becoming signatories to the United Nation's Principles for Responsible Investment. Third-party providers of ESG ratings and reports on portfolio companies – both public and private – have sprung up to meet growing investor demand for measurement of corporate ESG performance.

## Sustainability Proposals

The 2017 proxy season illuminated investors' sustainability concerns. One of the most common shareholder proposal topics this year involved environmental risk management and/or disclosure— with 144 such proposals, including 69 related to climate change, up slightly from 139 environmental proposals, including 63 climate change related proposals, in 2016. Similarly, shareholder voting support for climate change related proposals averaged 32% of votes cast this year, up approximately 7% from the prior year.[3] Notably, shareholder proposals seeking the publication of climate risk-management disclosures by Exxon Mobil, Occidental Petroleum and PPL Corporation garnered majority shareholder votes this year. On December 11, 2017, Exxon Mobil announced that its board of directors had reconsidered the company's previous opposition to the 2017 proposal of the New York State Common Retirement Fund – which had been approved by 62% of total votes cast in May 2017 – and decided to report on the impact of climate change policies in accordance with the parameters laid out in that proposal.[4] Occidental soon followed Exxon with a similar announcement; PPL published a climate assessment in November 2017.[5]

It remains to be seen whether the new Division of Corporation Finance interpretive guidance published in Staff Legal Bulletin (SLB) 14I, discussed in our Alert available here, will lead to any significant changes in the staff's disposition of "ordinary business" ((i)(7)) and "economic relevance" ((i)(5)) no-action requests from public companies seeking to exclude ESG shareholder proposals from their 2018 proxy statements. Much may depend on the degree of deference the SEC staff ultimately accords to any heightened level of board involvement in the oversight of management sustainability-related decisions stemming from the staff's application of SLB 14I. Another important variable is how corporate boards respond outside of the shareholder proposal process to investor sustainability concerns, and whether improved director-shareholder engagement in this area might obviate the need for shareholders to resort to the Rule 14a-8 no-action mechanism to express their views.[6] No matter what happens, this will be a critical space to watch during the 2018 proxy season, as the SEC staff responses to no-action requests applying the new board-centric analysis begin to emerge in the relatively near future.

In the meantime, the views of the major proxy advisory firms may affect the behavior of both companies and investors. ISS and Glass Lewis proxy voting guidelines generally support proposals addressing a variety of environmental concerns.[7] As discussed in our Alert available here, both proxy advisory firms expanded their policies on climate change-related shareholder proposals for the upcoming proxy season.

## Sustainability Reporting at a Glance: A Work in Progress

According to the Governance and Accountability Institute, approximately 82% of S&P 500 companies published some type of corporate sustainability report in 2016, up from 75% in 2015 and 20% in 2011.[8] In assessing the significance of this trend, it is helpful to distinguish between "mandatory" and "voluntary" sustainability disclosures.

Existing SEC rules require disclosure in periodic reports of information that falls within the broad ambit of the term "sustainability," such as "significant risk factors" (S-K Item 503(c)) and, in the MD&A, "known" trends, events, demands or uncertainties that are "reasonably likely" to have a material effect on a company's financial condition and/or results of operations (S-K Item 303).[9] Critics contend that these rules are either inadequately enforced by the SEC, or result in boilerplate disclosures that are not useful to investors. The SEC itself acknowledged widespread investor dissatisfaction with the quality of mandated sustainability disclosures in an April 2016 Concept Release on Disclosure Effectiveness.[10] That said, there is no indication that the SEC intends to pursue regulatory changes relating to the so-called "mandatory" sustainability disclosures that must be made in SEC-filed documents, thus leaving the field open for "private ordering" to continue – in the form of voluntary corporate sustainability disclosures posted on company websites or otherwise appearing outside the four corners of SEC filings.

Currently, there is no single, widely recognized disclosure framework governing the content of "voluntary" corporate sustainability reports. To the contrary, a variety of different organizations around the world have either developed, or are in the process of developing, their own disclosure standards. Among them are the Global Reporting Initiative (GRI), the Carbon Disclosure Project (CDP), the International Integrated Reporting Council (IIRC) and the U.S.-based Sustainability Accounting Standards Board (SASB). With a board comprised of (among others) two former SEC Chairs (Mary Schapiro and Elisse Walter), the current Chair of the TCFD (former NYC Mayor Michael Bloomberg), a former PCAOB Chair and SEC General Counsel (Daniel Goelzer) and a former SEC Division of Corporation Finance Director (Alan Beller), SASB is soliciting public comment on industry-specific standards for identifying and disclosing material corporate sustainability factors that can be included on a volitional basis in the MD&A and other sections of periodic reports.[11] Although the jury is still out as to which, if any, of these standards might prevail via private ordering, representatives from both the corporate and investor communities have expressed varying degrees of interest in, or outright support for, SASB's ongoing efforts.[12] To the extent generalizations are even possible at this early stage, however, it seems clear that not all companies share SASB's view – and that of the TCFD – that material sustainability-related information should be provided in SEC-filed documents.[13]

While many investors express dissatisfaction with the quality of corporate sustainability reporting,[14] they have yet to reach a consensus on such critical "gating" issues as: (1) whether they would prefer a single report that integrates key financial and non-financial performance indicators; (2) where they would like to see this disclosure appear (e.g., in SEC-filed documents rather than standalone sustainability reports); and (3) which of the many voluntary disclosure frameworks provides the most decision-useful information.

A few companies, such as General Electric, Clorox and JetBlue, have begun to experiment with integrating sustainability (i.e. non-financial) and financial information in a single report. For example, in addition to publishing a brief "corporate responsibility" report, JetBlue released a "white paper"[15] this year that discloses certain performance metrics calculated in accordance with SASB's voluntary disclosure framework for companies in the aviation industry. While typically made widely available on the company's website, these volitional disclosures generally have not been filed with, or furnished to, the SEC.

**What to Do Now:**

- Identify sustainability issues that could affect your company's performance and that may be material to an investor's understanding of your company's business and financial condition. In this regard, pay attention to what your institutional investors consider "material" for investment as well as proxy voting purposes. More on this below.
- Ensure the board's agenda provides ample time, on a regular basis, for oversight of the company's sustainability risk management practices and any related public disclosures – regardless of whether the information appears in a document filed with the SEC or posted on the company's website. It is important to note that, regardless of where such disclosures appear, all have potential liability exposure under the key antifraud provisions of the federal securities laws. Moreover, in the review and comment process, staff of the SEC's Division of Corporation Finance often look beyond the SEC filings themselves, and ask why certain risks and/or material developments disclosed "informally" to the public do not appear in such filings.
- Take a fresh look at board composition and director competency. The nominating and corporate governance committee should evaluate the composition of the board as a whole, as well as director skill sets and experiences to determine if the board is comprised of people with the optimal mix to oversee sustainability issues facing the company.
- Engage regularly with your major shareholders to understand their concerns and priorities in the broad area of sustainability. Additionally review any ESG voting guidelines your investors may have. Being proactive and responsive to shareholder concerns in this area might help a company avoid the negative attention attracted by shareholder proposals and costly proxy fights.
- Ensure that your SEC disclosures accurately state the material risks and uncertainties that your company may face in sufficient detail to allow investors to make informed investment and/or voting decisions.
- Understand where you stand vis-à-vis your peers with respect to sustainability reporting, as many environmental and social issues are not just faced by individual companies, but by entire industries. The recent experience of some U.S. energy companies, as discussed above, aptly illustrates this point.

## ENDNOTES

[1] Emily Chasen, *BlackRock Wields Its $6 Trillion Club to Combat Climate Risks,* Corp. Law & Account. Rep., Dec. 11, 2017. Established by the FSB in 2015, the Task Force published its final disclosure recommendations in late June 2017. *See* Final Report: Recommendations of the Task Force on Climate-related Financial Disclosure (June 29, 2017), *available here*.

[2] *See* F. William McNabb III, Chairman and CEO, Vanguard, "An Open Letter to the Directors of Public Companies," dated August 31, 2017, *available here*.

[3] Currently, 52% of the world's largest 250 companies by revenue do not acknowledge climate change as a financial risk in their annual reports. *See KPMG Survey of Corporate Responsibility Reporting 2017: The Road Ahead* (Oct. 2017), *available here*. The survey is based on the top 250 companies listed in the Fortune Global 500 ranking of 2016. Only 14% of KPMG's survey sample consisted of U.S. companies.

[4] *See* Exxon Mobil Corporation Form 8-K (filed Dec. 11, 2017), *available here*.

[5] Andrea Vittorio, *Occidental to Join Exxon in Reporting Climate Risks to Investors,* Corp. Law & Account. Rep., Dec. 14, 2017.

[6] *See* Virginia Harper Ho, *Sustainability in the Mainstream: Why Investors Care and What It Means for Corporate Boards,* The Conference Board (Nov. 2017), available here: https://theconferenceboard.attach.io/SyRpmg5lM.

[7] *See* ISS 2018 Americas Proxy Voting Guidelines Updates, *available here*; and Glass Lewis 2018 Proxy Guidelines on Shareholder Initiatives, *available here*.

[8] *See* G&A's Flash Report, *available here.* According to a recent survey, 78% of the world's largest 250 companies by revenue, and 81% of the top U.S. companies by revenue, include corporate responsibility information in their annual financial reports. *See KPMG Survey of Corporate Responsibility Reporting 2017: The Road Ahead* (Oct. 2017), *available here*.

[9] *See, e.g.,* See Securities and Exchange Commission Guidance Regarding Disclosure Related to Climate Change, 17 CFR Parts 211, 231 and 241, *available here*.

[10] *See* Securities and Exchange Commission Guidance Regarding Business and Financial Disclosure Required by Regulation S-K, 17 CFR Parts 210, 229, 230, 232, 239, 240 and 249, *available here*.

[11] *See* SASB Exposure Draft of the Standards, *available here.* The comment period ends on December 31, 2017.

[12] *See e.g.,* The Conference Board Press Release, *The Conference Board Joins Sustainability Accounting Standards Board (SASB) Council* (April 17, 2013), *available here.*; F. William McNabb III, Chairman and CEO, Vanguard, "An Open Letter to the Directors of Public Companies," dated August 31, 2017, *available here*.

[13] *See* SASB and Harvard Law School, *Legal Roundtable Report on Emerging Issues Related to Sustainability Disclosure* (Nov. 2017), *available here*; Virginia Harper Ho, *Sustainability in the Mainstream: Why Investors Care and What It Means for Corporate Boards,* The Conference Board (Nov. 2017), available here: https://theconferenceboard.attach.io/SyRpmg5lM. *See generally* The Conference Board, Conference Keynotes, *18 Truths about Sustainability: Insights from The 16th Annual Sustainability Summit* (New York City, July 18-19, 2017).

[14] According to a recent survey of institutional investors, which gathered responses from 320 decision-makers at buy-side institutions around the world, these investors have been disappointed by companies' ESG disclosures. Moreover, 60% of respondents believe that companies do not disclose ESG risks that could affect their business. *See* EY Poll: ESG Investor Survey, *available here*.

[15] *See* Jet Blue 2016 Sustainability Accounting Standards Board Report, *available here*.

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