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Disclosing ESG Matters: Advancing Nonfinancial Policy Through the SEC

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DISCLOSING ESG MATTERS: ADVANCING NONFINANCIAL POLICY THROUGH THE SEC

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INTRODUCTION

The United Nations Intergovernmental Panel on Climate Change ("IPCC") issued a jarring report on climate change in August 2021, stating that climate change is "widespread, rapid, and intensifying" and some of its effects are now "'irreversible.'"[1] IPCC scientists warned in the report that there no longer exists the luxury of time but that "global temperatures could stabilize" with "[s]trong and sustained reductions in emissions of carbon dioxide . . . and other greenhouse gases."[2] However, human activity has already caused climate effects, including extreme heat waves, heavy precipitation, prolonged droughts, and intensified storms.[3]

Eyes turn to governments to act. An unlikely actor in addressing climate change, the Securities and Exchange Commission ("SEC"), has taken modest steps since 2010 to increase public companies' climate-related and environmental disclosure.[4] Recently, in early 2021, the SEC, under then Acting Chair Allison Herren Lee, revived its efforts and began initiating actions toward more comprehensive and mandatory disclosure of environmental, social, and governance ("ESG") matters,[5] stating that "[c]limate [change]. . . is not just an EPA, Treasury, or SEC issue—it's a challenge for our entire financial system and economy."[6]

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[1] *IPCC Report: 'Code Red' for Human Driven Global Heating, Warns UN Chief*, U.N. (Aug. 9, 2021), https://news.un.org/en/story/2021/08/1097362 [https://perma.cc/EX8J-QRDS].

[2] *Id.*

[3] *Id.*

[4] *See, e.g.*, 17 C.F.R. § 6289 (2010).

[5] For the purposes of this Note, "ESG disclosure" will refer to climate change-related disclosure.

[6] Allison Herren Lee, *A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC*, U.S. SEC. & EXCH. COMM'N (Mar. 15, 2021), https://www.sec.gov/news/speech/lee-climate-change [https://perma.cc/6FCA-MNMB].

The importance of ESG- and climate-related matters to investors and the resulting action by the SEC has sparked new interest in the disclosure provided by public companies.[7] Lee noted in her March 2021 speech that "[i]nvestors are demanding more and better information on climate and ESG, and that demand is not being met by the current voluntary framework. Not all companies do or will disclose without a mandatory framework . . . ."[8] Further, Lee noted that the lack of standardization in ESG reporting deprives the investor of the ability to compare disclosure, and leaves open the question of reliability of the information provided by companies.[9]

This Note argues that mandatory ESG disclosure would be a valuable step in the larger fight against the deleterious effects of climate change. First, standardized disclosure would provide investors a better understanding of the climate risks associated with their investments by increasing the quality of that information supplied.[10] This standardization would be a valuable driver in corporate behavior because mandated disclosure tends to result in shifts in corporate behavior.[11] Previous examples of disclosure for nonfinancial risks, such as disclosure relating to state sponsors of terrorism and use of conflict minerals, illuminate how mandating ESG disclosure will deflect the pitfalls of voluntariness.[12]

First, Part I begins with the background of the SEC's efforts relating to climate change disclosure, as well as a general discussion of the current framework of disclosure.[13] Next, this Note will examine in Part II the issue of materiality, because it weighs heavily in the discussion in adopting disclosure requirements.[14] Parts III and IV review case studies

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[7] *See* Veronica Poole & Kristen Sullivan, *Tectonic Shifts: How ESG Is Changing Business, Moving Markets, and Driving Regulation*, DELOITTE (Oct. 29, 2021), https://www2.deloitte.com/us/en/insights/topics/strategy/esg-disclosure-regulation.html [https://perma.cc/8T64-PXBE].

[8] Lee, *supra* note 6.

[9] *Id.*

[10] *See* Javier El-Hage, *Fixing ESG: Are Mandatory ESG Disclosures the Solution to Misleading ESG Ratings?*, 26 FORDHAM J. CORP. & FIN. L. 359, 377–78 (2021).

[11] David A. Katz & Laura A. McIntosh, *SEC Regulation of ESG Disclosures*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 28, 2021), https://corpgov.law.harvard.edu/2021/05/28/sec-regulation-of-esg-disclosures/ [https://perma.cc/UC8P-Z4QN].

[12] *See infra* Parts III–IV.

[13] *See infra* Part I.

[14] *See, e.g.*, *The Materiality Debate and ESG Disclosure: Investors May Have the Last Word*, CLEARY GOTTLIEB (Jan. 11, 2022), https://www.clearygottlieb.com/news-and-insights/publication-listing/materiality-and-esg [https://perma.cc/L4Y3-LWEA]; *see also infra* Part II.

of nonfinancial disclosures.[15] The case studies include the following: (1) state sponsors of terrorism disclosure and (2) conflict minerals disclosure.[16] This Note argues in Part V that, in light of past nonfinancial disclosure requirements, a mandatory disclosure framework for ESG concerns will enhance environmental disclosure's clarity and utility to investors.[17]

I. BACKGROUND

In March 2021, the SEC's Acting Chair Lee spoke to a recognized shift in investor focus toward risks associated with climate change and the steps the SEC was planning to take to be an active participant in the solution.[18] The importance of climate change to the SEC, Lee notes, is drawn from the intersection of environmental risks and the SEC's regulatory framework.[19] Prior to Lee's speech, in February 2021, the Acting Chair directed the Division of Corporation Finance to increase its focus on public company filings regarding climate-related disclosure.[20] Among other actions and goals, the SEC created a Climate and ESG Task Force within the Division of Enforcement to heighten its enforcement against climate-related misstatements and gaps in disclosure by public companies.[21]

Eleven years prior to Lee's directive, the SEC issued guidance to public companies on how to apply existing disclosure requirements to climate-related matters.[22] In that interpretation, the SEC noted that the developments in legislation and regulation regarding climate change and environmental degradation, such as the Environmental Protection Agency's movement toward regulating greenhouse gas emissions under the Clean Air Act, would potentially affect public companies directly or indirectly.[23]

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[15] *See infra* Parts III–IV.
[16] *See infra* Parts III–IV.
[17] *See infra* Part V.
[18] Lee, *supra* note 6.
[19] *Id.*
[20] Allison Herren Lee, *Statement on the Review of Climate-Related Disclosure*, U.S. SEC. & EXCH. COMM'N (Feb. 24, 2021), https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure [https://perma.cc/QX3Z-94LJ].
[21] *Enforcement Task Force Announcement Is Latest Sign of SEC Focus on ESG and Climate*, KIRKLAND ELLIS (Mar. 8, 2021), https://www.kirkland.com/publications/kirkland-alert/2021/03/sec-climate-and-esg-task-force [https://perma.cc/T8J5-SW2M].
[22] *See* Commission Guidance Regarding Disclosure Related to Climate Change, Exchange Act Release Nos. 33-9106, 34-61469, Fed. Reg. 82, at 1–3 (Feb. 8, 2010) [hereinafter Commission Guidance].
[23] *Id.* at 3–6.

In lockstep, the SEC noted increasing investor calls for climate-related disclosures by these public companies.[24]

Under that guidance, the SEC outlined the rules requiring disclosure of climate change issues.[25] Under Item 101 of Regulation S-K, a company is required to describe its business, form of organization, products and services, customers, and more.[26] Information reported also must include the cost of compliance with environmental laws.[27]

Item 103 requires that a public company disclose material pending lawsuits to which the company or its subsidiaries is a party or which pertain to the company's property.[28] If a company knows of any legal proceedings that the government is contemplating, then it must disclose those proceedings under Item 103 as well.[29] Environmental litigation under Item 103 is elaborated upon by Instruction 5.[30] Although Item 103 normally excludes "ordinary routine litigation incidental to [a company's] business" from the disclosure requirements, Instruction 5 carves out environmental litigation from this exclusion, stating that legal proceedings that arise from governmental regulations concerning the protection of the environment or the discharge of materials into the environment are not considered legal proceedings "incidental" to the business.[31]

Next, Item 503(c) of Regulation S-K instructs a company to disclose "the most significant factors that make an investment in the registrant speculative or risky."[32] The Item states that the risk should be defined on its specificity to the company and the company should not list risks that are generally applicable to any company.[33] In this section, then, companies may not need to disclose the general risks that climate change poses to companies broadly. The next disclosure requirement, however, provides for greater room for companies to elaborate on climate change risks.[34]

Regulation S-K also requires disclosure under Item 303, the Management's Discussion and Analysis of Financial Condition and Results of

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[24] *Id.* at 7.
[25] *See id.* at 12–20.
[26] *Id.* at 12–13.
[27] *Id.* at 13.
[28] Commission Guidance, *supra* note 22, at 13.
[29] *Id.* at 13–14.
[30] *Id.* at 14.
[31] *Id.*
[32] *Id.* at 15.
[33] *Id.*
[34] *See* Commission Guidance, *supra* note 22, at 15.

Operations ("MD&A").[35] Under the MD&A section, the company should provide material information on the company's future prospects as to allow investors to ascertain the financial position of the company.[36]

The SEC recognizes that some of the information provided under this section may be nonfinancial information but, ultimately, it is information that will weigh on the company's financial prospects and performance.[37] Item 303 is broad, allowing for greater company discretion in its disclosure.[38] Although it demands that companies report on "known trends, events, demands, commitments and uncertainties" that may reasonably affect the company's financial situation or operations, the SEC has not required a certain future time period for ascertaining these events.[39] Instead, the future time period for these events is dependent on a company's particular situation and the characteristics of the actual trend or event.[40] Climate-related risks seem to fit well in this section of disclosure.[41] Because the impacts of climate change are likely to occur in some near future, and will likely impact companies in some way, companies would need to disclose both transitional risks as well as physical risks.[42]

These disclosures could include: effects of proposed climate legislation; cost of compliance with international agreements; costs and effects associated with compliance with national and regional greenhouse gas reduction mandates; investments into clean technology; and market pressures associated with the introduction of products friendly to the environment.[43] While MD&A may appear to be a relatively open space into which company disclosure could expand, the materiality requirement of this disclosure limits its scope.[44] Ultimately, the materiality requirement will exclude information that is unnecessary for enabling investors to

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[35] *Id.*
[36] *Id.* at 15–16.
[37] *Id.* at 16.
[38] *See id.*
[39] *Id.* at 16–17.
[40] Commission Guidance, *supra* note 22, at 17.
[41] Rick E. Hansen, *Climate Change Disclosure by SEC Registrants: REvisiting the SEC's 2010 Interpretative Release*, 6 BROOK. J. CORP. FIN. & COM. L. 487, 495–96 (2012).
[42] *See* Parker Bolstad, Sadie Frank, Erik Gesick & David Victor, *Flying Blind: What Do Investors Really Know About Climate Change Risks in the U.S. Equity and Municipal Debt Markets?* 2–3 (Hutchins Ctr. Fiscal & Monetary Pol'y at Brookings, Working Paper No. 67, 2020).
[43] Hansen, *supra* note 41, at 496.
[44] Commission Guidance, *supra* note 22, at 18.

better understand the financial position and operations of the company.[45] Even with this limitation, the MD&A section tends to be the most difficult section to draft for a report to the SEC.[46]

Finally, the SEC also requires disclosure by foreign issuers under Form 20-F.[47] Many of the required disclosures under Form 20-F are similar to those of Regulation S-K for domestic public companies.[48]

The issuance of the climate change disclosure guidance by the SEC followed studies that suggested that disclosure by public companies had poor climate change–related disclosure.[49] For example, in 2009, the North Carolina Journal of International Law and Commercial Regulation published an empirical study by Kevin Doran and Elias Quinn of 10-K filings by Standard & Poor's 500 ("S&P 500") members from 1995 to 2008.[50] Of the study's primary findings, the authors found that the majority of companies were silent on climate change in the 10-K filings and, if there was discussion of climate change, the discussion was not robust or informative.[51] In fact, only 5.5% of the S&P 500 companies named at least one climate change–related risk and discussed a strategy for addressing that risk.[52]

This is the guidance upon which Acting Chair Lee has called for next steps.[53] As part of its enhanced focus, the SEC will review how companies complied with and addressed climate change according to the 2010 guidance provided in the SEC's interpretation.[54] The SEC has also solicited public comments on how to develop a reporting framework that produces meaningful, measurable, and clear information on public companies' climate change efforts.[55] Looking back at other required nonfinancial disclosure may be a fruitful exercise for considering how the SEC

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[45] *Id.* For further discussion regarding the materiality issue, see *infra* Part II.
[46] Hansen, *supra* note 41, at 495.
[47] Commission Guidance, *supra* note 22, at 20.
[48] *Id.*
[49] Hansen, *supra* note 41, at 508.
[50] Kevin L. Doran & Elias L. Quinn, *Climate Change Risk Disclosure: A Sector by Sector Analysis of SEC 10-K Filings from 1995–2008*, 34 N.C. J. INT'L L. & COM. REG. 721, 723–24 (2009).
[51] *Id.* at 725–26.
[52] *Id.*
[53] Lee, *supra* note 6.
[54] *Id.*
[55] Allison Herren Lee, *Public Input Welcomed on Climate Change Disclosures*, SEC. & EXCH. COMM'N (Mar. 15, 2021), https://www.sec.gov/news/public-statement/lee-climate-change-disclosures [https://perma.cc/WFH4-N9K9].

should move forward with climate change– and ESG-related disclosure for public companies. This Note proceeds with such discussion. However, first, this Note briefly addresses the materiality issue which has generated considerable scholarly feedback on the reasonableness of requiring companies to disclose climate change– and ESG-related information.[56] Having noted that the issue is one with which, ultimately, the SEC will need to grapple, this Note continues to the case studies mentioned above to explore how nonfinancial information has fared in terms of disclosure in the SEC's recent history.

II. THE MATERIALITY ISSUE

Briefly discussed above, materiality is a major cornerstone for U.S. securities disclosure. Under the SEC's Rule 405, "material" acts as a qualifier for required information supplied by a company and is intended to limit such information "to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered."[57] This standard was adopted and applied after the U.S. Supreme Court handed down a decision in a 1976 case.[58]

The Supreme Court clarified materiality in the case of *TSC Industries, Inc. v. Northway, Inc.*[59] In assessing the purpose of the materiality requirement, the Court reasoned that the purpose of the requirement is to ensure that shareholders are making informed decisions.[60] The difficulty, the Court saw, is that materiality is subject to uncertainty, and overstating information that may be considered material "may accomplish more harm than good."[61] Lowering the materiality standard opens these reporting entities to greater liability for information that otherwise is thought to be insignificant to investors' decisions.[62] This lower standard of materiality would, in turn, induce companies to provide too much

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[56] David Lopez, Jared Gerber & Jonathan Povilonis, *The Materiality Debate and ESG Disclosure: Investors May Have the Last Word*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 31, 2022), https://corpgov.law.harvard.edu/2022/01/31/the-materiality-debate-and-esg-disclosure-investors-may-have-the-last-word/ [https://perma.cc/7SKF-7XB3].
[57] 17 C.F.R. § 230.405 ("Rule 405 of Regulation C").
[58] Hansen, *supra* note 41, at 499–500.
[59] *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 499 (1976).
[60] *Id.* at 448.
[61] *Id.*
[62] *Id.* at 448–49.

information and inundate investors, who then could not possibly make a sound decision due to information overload.[63] The Court held that materiality should be considered as follows: "an omitted fact is material if there is substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[64]

Introducing requirements for disclosure that relate to issues that are not strictly financial has invited great debate about the materiality standard.[65] The lobbyist group, the Business Roundtable, suggested in a 2015 publication that "[t]o the extent that [issues of societal concern, such as human trafficking and levels of political contributions,] deserve the attention of policymakers, none should be addressed through the required SEC disclosure framework for public companies, absent a materiality component."[66] Further, expanding the notion of materiality to include climate change–related disclosure increases the burden on companies by requiring them to discern how climate change risks will affect their business even when it is not obvious.[67]

Alternatively, some scholars have disagreed with resistance to disclosure regarding "issues of societal concern."[68] If materiality is defined, in essence, by what investors find important in making their investment decisions, and if investors have increasingly called for greater climate change– and ESG-related disclosure, that should allow for the extension of materiality to such issues.[69] Materiality is also context- and fact-specific.[70] Some sectors are clearly affected by climate change and environmental regulations, such as utilities and energy companies, while others are not.[71]

Professor Jill Fisch proposed a solution that addresses this materiality issue: a sustainability discussion and analysis ("SD&A") requirement to the current Regulation S-K, akin to the existing MD&A reporting

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[63] *Id.*
[64] *Id.* at 449.
[65] *See* BUS. ROUNDTABLE, THE MATERIALITY STANDARD FOR PUBLIC COMPANY DISCLOSURE: MAINTAIN WHAT WORKS 1–2 (2015) (arguing that disclosure addressing social issues disregards investor interest and lacks materiality as traditionally understood).
[66] *Id.* at 2.
[67] Camden D. Burton, *An Inconvenient Risk: Climate Change Disclosure and the Burden on Corporations*, 63 ADMIN. L. REV. 1287, 1296–97 (2010).
[68] BUS. ROUNDTABLE, *supra* note 65, at 2.
[69] *See* Cynthia A. Williams & Donna M. Nagy, *ESG and Climate Change Blind Spots: Turning the Corner on SEC Disclosure*, 99 TEX. L. REV. 1453, 1455–56 (2021).
[70] *See* Thomas Lee Hazen, *Corporate and Securities Law Impact on Social Responsibility and Corporate Purpose*, 62 B.C. L. REV. 851, 888–92 (2021).
[71] *See* Burton, *supra* note 67, at 1297.

requirement.[72] The proposed requirement would ask that public companies include known or reasonably known sustainability issues that are material to the company's business.[73] Professor Fisch's SD&A proposal avoids the difficult task of standardizing materiality for a wide range of public companies.[74] SD&A would also only ask that companies detail three of the "most material issues," "reduc[ing] the potentially burdensome impact associated with a more ambitious disclosure requirement."[75]

This argument regarding whether ESG- and climate change–related disclosure should be mandatory may be moot. In June of 2021, the House of Representatives proposed a bill titled the "ESG Disclosure Simplification Act of 2021" that stated: "[i]t is the sense of Congress that ESG metrics . . . are de facto material for the purposes of disclosures under the Securities Exchange Act of 1934 and the Securities Act of 1933."[76] As discussed in the case studies below, Congress has expanded the scope of materiality before.[77] Moreover, the SEC's Commissioner Lee suggested that information must not always be material in order for it to be required in disclosure.[78] Instead, Lee pointed out that the Securities Act of 1933 authorizes the SEC to create rules that require disclosure "in the public interest and for the protection of investors."[79] Materiality is not attached to this authorization.[80]

While this Note is not primarily concerned with the materiality issue that plagues the adoption of new disclosure requirements, it remains a top issue for the SEC, scholars, and public companies. Materiality inevitably has come into the discussion with the case studies reviewed

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[72] *See* Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L.J. 923, 923 (2019).
[73] *Id.* at 956–57.
[74] *Id.* at 957.
[75] *Id.*
[76] H.R. 1187, 117th Cong. (2021).
[77] *See supra* Parts III–IV; *see also Economy and Society: SEC Broadening Definition of Materiality*, BALLOTPEDIA NEWS (Mar. 23, 2021, 2:40 PM), https://news.ballotpedia.org/2021/03/23/economy-and-society-sec-broadening-definition-of-materiality/ [https://perma.cc/7PGC-XMD2].
[78] Vincent Ryan, *Materiality Question Dogs SEC's ESG Disclosure Project*, CFO (Aug. 17, 2021), https://www.cfo.com/regulation/2021/08/materiality-question-dogs-secs-esg-disclosure-project/ [https://perma.cc/4X3W-D65K]; Allison Herren Lee, *Living in a Material World: Myths and Misconceptions About "Materiality"*, U.S. SEC. & EXCH. COMM'N (May 24, 2021), https://www.sec.gov/news/speech/lee-living-material-world-052421 [https://perma.cc/78JM-ETX5].
[79] Lee, *supra* note 78.
[80] *Id.*

below. This section sought to review one of the major roadblocks to mandatory ESG-related disclosure and to air the grievances of those opposed to more or less expanding the materiality threshold to allow for environmental risks to be included in companies' reports.

III. STATE SPONSORS OF TERRORISM DISCLOSURE MANDATE

A. *Background*

Following the September 11, 2001, attacks, Congress directed the SEC to review disclosure by public companies regarding their activities in or with countries designated as "state sponsors of terrorism" ("SSTs") by the U.S. Department of State.[81] A House Committee on Appropriations report stated: "[t]he Committee believes that a company's association with sponsors of terrorism and human rights abuses, no matter how large or small, can have a material adverse effect on a public company's operations, financial condition, earnings, and stock prices, all of which can negatively affect the value of an investment."[82] Further, the Committee instructed the establishment of an Office of Global Security Risk ("OGSR") which would, in part, implement heightened disclosure requirements for the risk associated with companies' activities in these SSTs.[83] The countries labeled as SSTs are Iran, Cuba, Syria, and North Korea.[84]

B. *Implementation*

Disclosure may occur by way of Regulation S-K, which lists categories of information that must be disclosed by a public company.[85] In particular, Item 101 of Regulation S-K asks for a general business description, which should include information about where business is conducted, primary markets for the company's products, and the sources

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[81] Bill Mayew, Robert Hills & Matt Kubic, *When the SEC Asks About Terrorism, It Misses Financial Misreporting*, LAWFARE (June 6, 2021, 10:01 AM), https://www.lawfareblog.com/when-sec-asks-about-terrorism-it-misses-financial-misreporting [https://perma.cc/3WQ9-QM5Q].
[82] H.R. Rep. No. 108-221, at 151 (2004).
[83] *Id.*
[84] *State Sponsors of Terrorism*, U.S. DEP'T OF STATE, https://www.state.gov/state-sponsors-of-terrorism/ [https://perma.cc/8LP4-DDGW] (last visited Jan. 16, 2023).
[85] Amy Deen Westbrook, *What's in* Your *Portfolio? U.S. Investors Are Unknowingly Financing State Sponsors of Terrorism*, 59 DEPAUL L. REV. 1151, 1183 (2010).

for the company's raw materials.[86] Moreover, Item 303 of Regulation S-K instructs a company to discuss "'trends, events, and uncertainties'" that may reasonably affect a company's operations, liquidity, or capital resources.[87] Disclosure may also be required under Exchange Act Rule 12b-20 ("Rule 12b-20").[88] Rule 12b-20 requires that additional information must be given in a statement or report if it is "necessary to make the required statements."[89] None of these, however, specifically mandate a company to disclose its interactions with or business connections to SSTs.[90]

While the disclosure of whether a company conducts business in or with a listed country is not as straightforward as the Conflict Minerals Rule,[91] the SEC had taken significant interest in clarifying companies' dealings with SSTs.[92] Clarification was often accomplished via comment letters.[93] The Division of Corporate Finance will periodically review company filings and send comment letters if it finds potential deficiencies in disclosure.[94]

For example, the SEC issued a comment to Kraft Heinz about its ketchup product being available in Cuba and Iran.[95] The OGSR sent the letter to the Heinz Kraft company's Chief Financial Officer after having reviewed its Form 10-K filing.[96] Companies that receive these letters would often respond in such a way that would conclude the issue raised by the OGSR was immaterial.[97]

The SEC tasked the OGSR with identifying all companies traded on U.S. exchanges that were operating in SSTs and, of those companies,

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[86] *Id.*
[87] *Id.* at 1184.
[88] *See* 17 C.F.R. § 12b-20 (2009).
[89] *Id.*
[90] Westbrook, *supra* note 85, at 1183.
[91] Unlike the Conflict Minerals Rule, there is not a special and separate disclosure requirement for dealings with SSTs statutorily mandated to the SEC. See *infra* Part IV.
[92] *See* Mayew et al., *supra* note 81.
[93] Robert Hills, Matthew Kubic & William J. Mayew, *Does State Sponsor of Terrorism Disclosure Limit SEC Financial Reporting Oversight?*, CLS BLUE SKY BLOG (May 19, 2020), https://clsbluesky.law.columbia.edu/2020/05/19/does-state-sponsor-of-terrorism-disclosure-limit-sec-financial-reporting-oversight/ [https://perma.cc/M54T-4JDD].
[94] Mayew et al., *supra* note 81.
[95] *Id. See also* Letter from Cecelia Byle, Chief, Off. of Glob. Sec. Risk, to Arthur B. Winkleblack, Exec. Vice President and Chief Fin. Officer, H. J. Heinz Co. (Sept. 27, 2012) [hereinafter Heinz Letter], https://www.sec.gov/Archives/edgar/data/46640/000000000012053334/filename1.pdf [https://perma.cc/YRG9-96DQ].
[96] Heinz Letter, *supra* note 95.
[97] Westbrook, *supra* note 85, at 1214.

those who are disclosing that fact to investors.[98] In an effort to facilitate its task, OGSR proposed reviving a web tool that would allow investors to search information regarding a reporting company's business in SSTs.[99] However, this proposed tool was not welcomed by businesses[100] and was ultimately suspended for failing to distinguish between legitimate business activities allowed by the U.S. government and those that might contribute to terrorism.[101]

C. *SST Disclosure Results*

The resulting disclosure arising from Regulation S-K, Rule 12b-20, and the OGSR letters is less than ideal. A study of about 140 companies suggests about less than half reported their activities with SSTs and even fewer companies "meaningfully disclosed those activities."[102]

Moreover, the OGSR letters sent to companies suspected of deficient SST disclosure do not fulfill the purposes of disclosure.[103] The letters that are publicly available lack standardization, thereby making it difficult for investors to compare with others' disclosure and may contain redacted information.[104]

IV. CONFLICT MINERALS DISCLOSURE

A. *Background*

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which contained section 1502, commonly known as the "conflict minerals" provision.[105] This

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[98] *SEC Seeks Comments on Disclosures of Business Activities in Cuba, Iran, North Korea, and Syria*, GIBSON DUNN (Nov. 27, 2007), https://www.gibsondunn.com/sec-seeks-comments-on-disclosures-of-business-activities-in-cuba-iran-north-korea-sudan-and-syria/ [https://perma.cc/8EWA-CPRR].
[99] *Id.*
[100] *See* Press Release, Sec. & Exch. Comm'n, Statement by Securities and Exchange Commission Chairman Christopher Cox Concerning Companies' Activities in Countries Known to Sponsor Terrorism (July 20, 2007), https://www.sec.gov/news/press/2007/2007-138.htm [https://perma.cc/2ELE-R3TE].
[101] *Id.*
[102] Westbrook, *supra* note 85, at 1217.
[103] *Id.* at 1216–17.
[104] *Id.*
[105] *US Conflict Minerals Law*, GLOB. WITNESS (Nov. 15, 2017), https://www.globalwit

provision instructed the SEC to adopt a rule that required public companies to disclose whether certain raw materials, including tin, tungsten, tantalum, and gold, found in their products had originated from the Democratic Republic of Congo ("DRC") or its neighboring countries.[106] Pursuant to the Dodd-Frank Act, the SEC issued a final rule effective in 2012 that implemented this decree from Congress as well as supporting measures.[107]

If a public company finds that its products do contain conflict minerals from the DRC or an adjoining country, then the company must submit a report to the SEC indicating the steps the company took to exercise due diligence on the mineral source and "chain of custody."[108] The company must have obtained an independent audit of that report, must name the auditor, and must certify the audit.[109] Furthermore, the report must include information on the products that are classified as containing conflict minerals, such as a description of the products manufacturer, the facilities that process those conflict minerals, the country of origin of those conflict minerals, and the company's efforts to locate the mine or the origin of those conflict minerals.[110]

The SEC in its issuance of the final rule states that the purpose of this disclosure was to reflect Congress's concern regarding the humanitarian issues and violent conflict in the DRC.[111] "Congress chose to use securities laws disclosure requirements to bring greater public awareness of the source of issuers' conflict minerals and to promote the exercise of due diligence on conflict mineral supply chains."[112] By doing so, Congress intended that the increased disclosure would reduce use of conflict minerals, which were used to fund armed groups that contributed to the conflict ongoing in the DRC.[113] Reduced use of conflict minerals would promote "the protection of human rights within the global supply chain."[114]

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ness.org/en/campaigns/conflict-minerals/dodd-frank-act-section-1502/ [https://perma.cc/4RXK-F7BX].

[106] *Id.*

[107] Conflict Minerals Rule, 17 C.F.R. §§ 240, 249b (2012).

[108] *Id.*

[109] *Id.*

[110] *Id.*

[111] *Id.*

[112] *Id.*

[113] 17 C.F.R. §§ 240, 249b.

[114] Fatima Alali & Sophia I-Ling Wang, *Conflict Minerals Disclosure Requirements and Corporate Social Responsibility*, CPA J. (July 2018), https://www.cpajournal.com/2018/07/18/conflict-minerals-disclosure-requirements-and-corporate-social-responsibility/ [https://perma.cc/DTQ7-J3D9].

B. *Implementation of the Conflict Minerals Disclosure Rule*

Per its statutory directions, the SEC adopted the conflict minerals disclosure rule (hereinafter "Conflict Minerals Rule") in 2012.[115] The rule covers any company already subject to reporting requirements under the Securities and Exchange Act, meaning that the rule does not encompass private, non-reporting entities.[116] Next, the rule then asks whether, among those reporting companies, that company necessarily utilizes conflict minerals in their products.[117] If the company qualifies under that language, then the company must conduct a "reasonable country of origin inquiry" ("RCOI") to determine from where the conflict mineral originated, and must file a Specialized Disclosure Report ("Form SD").[118] Next, a company must complete a due diligence check on the source and supply chain of the conflict minerals used in their products and file a Conflict Minerals Report ("CMR") as an exhibit to the Form SD to document the company's findings.[119]

In 2014, the SEC amended Conflict Minerals Rule pursuant to a lawsuit that challenged the requirement that companies state on their company website and report to the SEC that any one of their products have been identified as not "DRC conflict-free."[120] The U.S. District Court for the District of Columbia found that the provision violated the First Amendment.[121] However, if a company voluntarily elects to describe its product as "DRC conflict-free," then it must obtain an independent private sector audit in their CMR.[122]

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[115] U.S. GOV'T ACCOUNTABILITY OFF., SEC CONFLICT MINERALS RULE: COMPANIES FACE CONTINUING CHALLENGES IN DETERMINING WHETHER THEIR CONFLICT MINERALS BENEFIT ARMED GROUPS 9 (2016), https://www.gao.gov/assets/gao-16-805.pdf [https://perma.cc/HD97-86JU].
[116] 17 C.F.R. §§ 240, 249b.
[117] *Id.*
[118] Alali & Wang, *supra* note 114.
[119] 17 C.F.R. §§ 240, 249b; Alali & Wang, *supra* note 114.
[120] Alali & Wang, *supra* note 114; *see also* Keith F. Higgins, *Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule*, U.S. SEC. & EXCH. COMM'N (Apr. 29, 2014), https://www.sec.gov/news/public-statement/2014-spch042914kfh [https://perma.cc/SLP3-BQ5U].
[121] Michael S. Piwowar, *Statement of Acting Chairman Piwowar on the Court of Appeals Decision on the Conflict Minerals Rule*, U.S. SEC. & EXCH. COMM'N (Apr. 7, 2017), https://www.sec.gov/news/public-statement/piwowar-statement-court-decision-conflict-minerals-rule [https://perma.cc/YA9A-RVYE].
[122] Alali & Wang, *supra* note 114.

As a result of the lawsuit, the SEC issued guidance in 2017 that suggested SEC staff would not recommend enforcement actions if a company failed to disclose its due diligence process due to the uncertainty regarding how the SEC commissioners would resolve the First Amendment issues presented.[123] Despite this guidance, the SEC may still move forward with enforcement proceedings should a company fail to report its due diligence pursuant to the Conflict Minerals Rule.[124]

C. *Conflict Minerals Disclosure Results*

Per the Dodd-Frank Act, the U.S. Government Accountability Office ("GAO") has issued reports analyzing companies' response to the conflict minerals disclosure rule since 2014.[125] The GAO "analyzed a generalizable sample of 100 SEC filings; reviewed SEC documents; and interviewed SEC officials and other stakeholders . . . ."[126]

The number of CMRs declined from 2014 to 2020, reflecting that fewer companies have filed disclosure reports since 2014.[127] The trend may be attributable either to mergers and acquisitions among companies that have filed disclosure previously or to an industry shift toward substitute materials that do not qualify as conflict minerals.[128] The rate at which companies conducted inquiries into the country of origin of the conflict minerals (i.e., the RCOI) has remained relatively stable since 2015.[129] Consistent with this finding, the GAO also found that the percentage of companies that conducted due diligence into the source of their conflict minerals remained consistent with previous years, as well.[130]

The common difficulties companies cited with regards to Conflict Minerals Rule disclosure included: (i) lack of access to suppliers due to complexity of the supply chain; (ii) for due diligence, suppliers' survey responses were inadequate due to a lack of specificity in the smelters and

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[123] U.S. GOV'T ACCOUNTABILITY OFF., CONFLICT MINERALS: 2020 COMPANY SEC FILINGS ON MINERAL SOURCES WERE SIMILAR TO THOSE FROM PRIOR YEARS 9–10 (2021) [hereinafter GAO REPORT 2021], https://www.gao.gov/assets/gao-21-531.pdf [https://perma.cc/9RQG-D9AS].
[124] *Id.*
[125] *See id.* at 9.
[126] *Id.* at 1.
[127] *Id.* at 10–11.
[128] *Id.* at 11 n.22.
[129] GAO REPORT 2021, *supra* note 123, at 12–13.
[130] *Id.* at 14–15.

refiners; and (iii) suppliers failed to respond to survey requests due to a lack of business relationships with lower stream suppliers.[131]

Professor Jeff Schwartz examined over 1,300 conflict minerals disclosure filings and assessed the content and quality of the disclosure.[132] Among his findings, Schwartz notes that the disclosure was less costly and less burdensome than previously thought by some critics.[133] However, the low level of cost may be attributable to a low level of effort.[134] As the GAO noted, companies have had a difficult time receiving fully fleshed-out information from suppliers, and this lack of information may be advantageous for companies who would prefer no news rather than bad news.[135]

Whether or not the disclosure requirement is accomplishing the purpose of steering companies away from sourcing its minerals from the DRC or adjoining countries is debatable. Since the Dodd-Frank Act's passing and the implementation of the Conflict Minerals Rule, the DRC's president banned mining in two of the country's provinces, other international efforts have focused on shifting away from conflict minerals in the DRC, and there may be alternatives resources available.[136] For example, larger market forces may have incentivized companies to choose suppliers that source minerals outside of the DRC or its surrounding areas. The likelihood that the disclosure alone "shamed" corporations into seeking new suppliers is minimal because many of these companies were unable to truly pinpoint the source location.[137] Instead, companies learned more about what they did not know about their supply chain.[138]

V. COMPARING DISCLOSURE

Reviewing the SST and conflict minerals disclosure regimes illuminates the pitfalls of nonfinancial disclosure. Neither the SST nor the conflict mineral disclosure ultimately resulted in high-quality and abundant reporting by companies.[139] Nor can it be argued that either disclosure

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[131] *Id.* at 19.
[132] *See* Jeff Schwartz, *The Conflict Minerals Experiment*, 6 HARV. BUS. L. REV. 129, 131 (2016).
[133] *Id.* at 158–59.
[134] *See id.*
[135] *Id.* at 159–60.
[136] *Id.* at 171–72; GAO REPORT 2021, *supra* note 123, at 11 n.22.
[137] GAO REPORT 2021, *supra* note 123, at 14–15.
[138] *See id.*
[139] *See supra* Sections III.C, IV.C.

shifted corporate behavior away from unfavorable conduct.[140] However, the problems that weakened the efficacy of these disclosures need not plague the new ESG disclosure requirements.

The policy goals associated with SST and conflict minerals were both nonfinancial in nature, but that nonfinancial nature did not necessarily undermine the efficacy of the disclosure. Rather, the lack of specificity in the SEC's disclosure requirements undermined the possible achievements.[141] For example, the SST disclosure came on the heels of a major terrorist attack on U.S. soil and sought to make transparent company dealings with or in states designated as SSTs.[142] The U.S. government could not prevent domestic entities from forming foreign subsidiaries and conducting business in Syria, for example, but it could require that those entities report to investors when they do.[143]

The issue, however, was that companies leveraged the materiality issue to avoid disclosure.[144] Namely, companies would reason that the activities in or with SSTs were financially insignificant and therefore immaterial to the investor.[145] As discussed in Part II, materiality is a large hurdle for nonfinancial disclosure.[146] The conflict minerals disclosure is a good example of one way to overcome that hurdle.

The conflict minerals disclosure reflects Congress's intent to make known a company's indirect involvement in a humanitarian crisis.[147] Disclosure would both illuminate the company's use of conflict minerals in its supply chain for the knowledge of investors and this information would thereby shift companies away from conflict mineral use, ultimately promoting humanitarian policy.[148] This was accomplished by requiring disclosure in greater specificity than was required by SST disclosure.[149] If conflict minerals were thought to be involved in a company's supply chain, then a company had to make a reasonable investigation into its supply chain and report its findings.[150]

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[140] *See supra* Sections III.C, IV.C.
[141] *See* Schwartz, *supra* note 132, at 155, 164–65.
[142] Westbrook, *supra* note 85, at 1152–53.
[143] *Id.*
[144] *See id.* at 1212–14.
[145] *Id.*
[146] *See supra* Part II.
[147] Conflict Minerals Rule, 17 C.F.R. §§ 240, 249b (2012).
[148] *Id.*
[149] *See id.*; *supra* Section III.A.
[150] 17 C.F.R. §§ 240, 249b.

Unlike the SST disclosure, the conflict minerals disclosure had the advantage of targeting a distinct component of a business's operations: the source of minerals used in the business's goods.[151] The SST disclosure, on the other hand, focused on any and all material connections with any of the listed countries,[152] which encapsulates a broader swath of a business's operations. Because the possible scope of disclosure is larger for SST disclosure in terms of what the company might disclose, the company also receives a greater level of discretion in determining whether information is pertinent to the investor.[153] In other words, a company can determine that the sale of their goods within a listed country is unimportant because it constitutes a minuscule percentage of the company's total sales, even if that small percentage of sales is socially significant.[154]

Nevertheless, both SST and conflict minerals disclosure provided incomplete or inadequate information. For SST, this is likely attributable to the issues discussed above—the lack of specificity allowed companies to contend that the information was immaterial.[155] For conflict minerals disclosure, however, the poor quality disclosure may be mostly attributable to the nature of the supply chain: Companies relied upon third parties to supply information and had no incentive to seek high-quality information.[156] The larger the degree of removal from the source, the less the company could adequately disclose the source of its minerals.[157] Though companies learned more about their supply chain, it is more likely that they learned what they did not know.[158] While understanding what companies do not know could be considered a step forward, it does not necessarily help to inform investor decisions if they are seeking to avoid investments in companies that deal with conflict minerals.

The ESG disclosure can avoid some of these pitfalls if the SEC adopts concrete and specific mandatory disclosure requirements. Mandatory ESG disclosure would encourage complete, consistent, and comparable disclosure among companies and industries.[159] Moreover, the mandatory framework would enable a uniform enforcement of ESG disclosure, unlike

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[151] *Id.* § 240.13p-1.
[152] *See* Westbrook, *supra* note 85, at 1183, 1185.
[153] *See id.*
[154] *See Should the SEC Expand Nonfinancial Disclosure Requirements?*, 115 HARV. L. REV. 1433, 1436 (2002).
[155] *See* discussion *supra* Section III.C.
[156] *See* GAO REPORT 2021, *supra* note 123, at 19.
[157] *See id.* at 17, 19.
[158] *See, e.g.*, *id.* at 14–15, 17.
[159] *See* El-Hage, *supra* note 10, at 377–78.

under the SST disclosure framework in which comment letters were used, in a way, like informal enforcement.[160]

Furthermore, because ESG covers a wide range of corporate behavior, including a business's climate change response efforts and internal corporate culture,[161] the SEC should adopt discrete guidelines to reporting. ESG disclosure mirrors SST disclosure in that it covers a wide range of corporate behavior and concerns information that should be discoverable by the corporation.[162] Unlike the conflict minerals disclosure, ESG disclosure does not necessarily require companies to seek out and rely on outside parties to provide information for their disclosure.[163]

CONCLUSION

Reviewing past disclosure requirements concerning social policy goals, such as a company's connections with SSTs or the extent of a company's use of conflict minerals in their supply chain, may be a fruitful method for weighing the current decision facing the SEC: whether the agency should adopt mandatory ESG disclosure requirements for reporting companies. The current voluntary ESG disclosure framework is plagued by inconsistency across industries and between companies, which can lead to confusing and potentially misleading information for investors.[164]

This Note looks to two social policy disclosure frameworks to argue that the SEC should mandate ESG disclosure. First, the SST disclosure requirement suggests that voluntary disclosure and *ad hoc*, informal enforcement via comment letters did not alleviate the issues associated with poor disclosure.[165] Second, the conflict minerals disclosure cured some of the issues by mandating disclosure and outlining a clear process for all companies subject to the disclosure.[166] Even though the conflict minerals disclosure still lacked high-quality information, this is more attributable to companies' reliance on outside sources to supply data.[167] ESG disclosure, however, does not necessarily rely on third

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[160] Mayew et al., *supra* note 81.
[161] El-Hage, *supra* note 10, at 363.
[162] *See id.*; *see also* GAO REPORT 2021, *supra* note 123, at 2.
[163] *See* El-Hage, *supra* note 10, at 363; *see also* GAO REPORT 2021, *supra* note 123, at 2.
[164] El-Hage, *supra* note 10, at 365–70.
[165] *See* Westbrook, *supra* note 85, at 1202–03.
[166] *See supra* Section IV.A.
[167] *See* Schwartz, *supra* note 132, at 148–49.

parties to supply information in the same manner. Rather, ESG disclosure concerns matters internal to the corporation that can be more readily discovered.

Mandatory ESG disclosure has the potential to accomplish what prior social policy disclosure did not. Should the SEC adopt mandatory disclosure with clear and concrete guidance, then investors can be better informed when integrating ESG into their investment portfolios.