The Legal Intelligencer

The Evolving Definitions of Materiality and Sustainability Reporting

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May 7, 2013

Is "sustainability" material to the reasonable investor? Under the securities laws, publicly traded companies are required to disclose to their shareholders and the investing public "material" information about their company. In *TSC Industries v. Northway*, 426 U.S. 438 (1976), the U.S. Supreme Court defined "material information" as that which "presents a substantial likelihood that disclosure of the omitted fact would have been viewed by the 'reasonable investor' as significantly altering the 'total mix' of information made available."

In other words, material information is information that a reasonable investor would consider important in making an investment decision. Unfortunately, there is no bright-line rule as to what facts, or omissions of facts, a reasonable investor would consider important. Over the years, many issues have surfaced as to what nonfinancial information could, and would, be material to investors. Most recently, a discussion has been brewing about the materiality of sustainability. The investment community has been considering the materiality of sustainability disclosures to its investment decisions. As is often the case in these situations, there is a discernible tension between investors, who seek to expand mandatory disclosure rules, and company management.

Sustainability, simply defined, is the capacity to endure. In a business context, this capacity is brought about by identifying and then balancing current social, environmental and economic opportunities and risks, and then managing them with a long-term perspective. It differs considerably from the quarter-to-quarter thinking and mono-focus on shareholder return that many companies are forced to endure today. Most notably, sustainability requires that the much broader set of social, environmental and economic impacts be considered in all decision-making, and that decisions be made with concern for their social, environmental and economic consequences well into the future. The promise of sustainability is that an increased capacity to endure ultimately delivers greater value to shareholders.

Over the past 10 to 15 years, many businesses — particularly large, publicly traded companies — have been incorporating a wider range of environmental, social and governance (ESG) factors into their planning as well as their decision-making. Such efforts have been shared in communications to investors because many of those involved in these efforts see the value of more effectively identifying opportunities and managing risks across this broader range of issues and topics.

Companies began communicating with respect to the particular sustainability matter of climate change in filings with the Securities and Exchange Commission in response to SEC rules. Companies for some time have also issued annual voluntary sustainability reports, or submitted specific reports relating to significant climate change risks and opportunities to groups such as the Carbon Disclosure Project (CDP). The CDP reporting structure requires companies to explore various types of climate change-related risks and opportunities and to report on those that are material to the company and its investors. General sustainability reports typically offer a wide range of disclosures on efforts by these companies to identify and mitigate ESG risks and negative impacts. Many sustainability reports follow the Global Reporting Initiative (GRI) reporting framework, which emphasizes reporting on environmental, social, economic and governance factors that are material to a company and its stakeholders as opposed to just shareholders. In issuing these reports, the public disclosures by the reporting companies have expanded beyond the more traditional disclosures found in the annual reports on Form 10-Ks of these companies filed with the SEC.

In 2010, the SEC issued an interpretive release in response to growing shareholder activism and pressure from the investor community with respect to climate-change disclosures. In the release, the SEC affirmed that the materiality analysis applies to the subject of climate change. The release articulated an expectation that companies will examine risks that climate change poses to them and make appropriate disclosures if those risks are material.

While the SEC release brought climate-change issues such as those covered in CDP reports and GRI-based sustainability reports more prominently into the SEC mandatory disclosure conversation, it did not frame or benchmark the materiality of those issues, nor did it reach the broader range of issues encapsulated in the concept of sustainability — issues such as ethics and codes of conduct, executive compensation, integration of ESG factors into decision-making, risk management, diversity, stakeholder engagement, reduction of resources consumption and waste, talent attraction and retention, fair labor practices or human rights, and many more areas of concern within the umbrella of a company's governance practices and environmental, social and economic impacts.

Given the wide range of sustainability issues, even a moderate level of investigation underlying the development of a sustainability reporting strategy can present big data concerns for large companies. To make matters more complicated, many sustainability issues that are material to one industry (or even an industry subgroup) are not material to another industry (or subgroup), and vice versa. Identifying and prioritizing these wide-ranging sustainability issues by their materiality to a "reasonable investor" is difficult, time-consuming and often confusing in the absence of clear standards. Many companies err on the side of reporting on all sustainability efforts, material or not, rendering their reports so voluminous, rambling and diluted as to be of diminished value. Companies and investors alike struggle with what should be included and what should be left out of sustainability reporting to make it meaningful and useful. As a result of the sustainability reports being published, companies must consider what should be disclosed in their filings with the SEC.

The Sustainability Accounting Standards Board (SASB) was formed in July 2011 to address the current debate regarding mandatory disclosure with respect to sustainability reporting. The SASB is working to identify sustainability issues that are material to investors across 88 industries in 10 sectors, and to develop standards for sustainability disclosures in SEC reports. The organization has identified 43 sustainability issues, which serve as the starting point for establishing which of those issues are material for each particular industry. The industry-specific material issues and related "decision-useful" standards for decision-making on Form 10-K and Form 20-F disclosures on those issues are being established through a diverse, inclusive and consensus-based process. Of course, such standards will not necessarily be required unless, and until, the SEC approves them. With or without such standards, materiality, however, must still be considered.

SASB's standards, if widely adopted, will reduce the clutter and noise that is inherent in much of today's sustainability reporting and provide much-needed guidance for SEC reporting on material information. The concept of materiality, however, is dynamic and changing. The SASB's lists of material issues will evolve and should not be viewed as a substitute for more broadly based decision-making processes that underlie capacity building for endurance and long-term shareholder value that are company-specific. The SASB is creating a safe harbor, with a changing shoreline, in a turbulent world where those who venture forth will still find it very valuable to keep an eye on the broad horizon of where environmental, social and economic risks and opportunities are explored. Time will tell in which direction the tide of disclosure will move with respect to sustainability reporting. It is important for companies to keep their eyes open with respect to the tide and take advantage of the opportunities posed and protect against the risks presented.

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