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Nonfinancial Risk Disclosure and the Costs of Private Ordering

By Virginia Harper Ho January 22, 2018

2017 was a year of major developments that are changing how companies disclose nonfinancial environmental, social, and governance (ESG) risk to investors. In January, regulations implementing the European Union's 2014 Nonfinancial Reporting Directive took effect for certain large companies operating in Europe and the U.K. Under these rules, affected companies must prepare a non-financial statement disclosing material environmental, social, human rights, anti-bribery, and diversity matters. In March, Nasdaq's Nordic and Baltic stock exchanges introduced voluntary ESG reporting guidelines as part of their contribution to the United Nation's Sustainable Stock Exchanges initiative on nonfinancial disclosure reform. And in June, the Task Force on Climate-Related Disclosure (TCFD), which was formed by the Financial Stability Board (FSB) of the G20, produced its final recommendations and voluntary reporting guidance for companies to use in considering how to measure and disclose the financial impact of climate-related risk in their annual reports.

In the U.S., the SEC has encouraged public companies to consider the materiality of climate-related risk under existing reporting requirements and to report material nonfinancial information necessary to render required disclosures not misleading. But investors increasingly express dissatisfaction with the quality of nonfinancial information companies provide,[1] and over 80 percent of the comments the SEC received to its 2016 Concept Release on Regulation S-K supported nonfinancial disclosure reform.[2] Still, the current administration's deregulatory stance means that the SEC is unlikely to consider new approaches to ESG disclosure anytime soon, and its recently proposed changes to Regulation S-K are silent on the question of nonfinancial disclosure.

For now, then, investor access to nonfinancial information from public companies subject to U.S. disclosure rules will continue to depend almost entirely on various forms of private ordering —shareholder proposals targeting companies' ESG risk management and transparency, private standard-setting organizations' ESG reporting frameworks, and companies' own voluntary sustainability reports.

In my forthcoming article, Nonfinancial Risk Disclosure & the Costs of Private Ordering, I argue that this model of nonfinancial risk disclosure is ›ffective and produces costly information asymmetries. Private ordering has raised companies' (and investors') awareness of ESG materiality and increased the quantity of information ESG information reaching the market, but it cannot meet investor demand for the kind of reliable, comparable information that investment analysis requires and that is fundamental to efficient capital allocation.

I also argue that relying on private ordering to provide decision-useful information on nonfinancial risks imposes costs not just on investors, but also on public companies, regulators, and the capital markets as a whole, and that these costs have been largely overlooked in current debates over the future of disclosure reform.

- Costs to Markets: There is growing evidence that relying on private ordering to generate nonfinancial risk disclosure produces costly market-wide information asymmetries and may be a source of systemic risk within the financial system.
- Costs to Investors: A basic justification for mandatory disclosure is that private ordering forces investors to bear higher costs to identify and analyze information that is not readily comparable or consistently verified. Investors also bear the costs of engaging directly with firms and negotiating for more or better information on a case-by-case basis.
- Costs to Reporting Companies: Responding to inquiries, surveys, and shareholder proposals on an ad hoc and unpredictable basis also imposes costs on public companies. Companies that disclose ESG information in a separate sustainability report face uncertain liability risks, and the SEC's lack of clear guidance on nonfinancial disclosure also creates costly ambiguity for reporting companies.
- Costs to the SEC: At a practical level, the SEC must devote greater staff resources to no-action review of a rising number of ESG shareholder proposals when investors must rely on self-help to obtain information on nonfinancial risks. Now that over 35 other jurisdictions already encourage or require some form of ESG disclosure under corporate law, financial regulation, or stock exchange listing rules, the SEC's inaction on ESG disclosure also puts it out of step with other leading capital markets and may cost it an opportunity to shape international dialogue and emerging best practices for nonfinancial disclosure.

My article argues that the SEC should develop a framework for material nonfinancial information disclosure as part of its ongoing reforms of risk-related disclosure in financial reporting. The article also contributes to the SEC's ongoing disclosure reform project by proposing a range of approaches to improve nonfinancial risk disclosure that balance flexibility and standardization, as well as the costs and benefits for reporting companies and investors. Although current debates seem to assume a false choice between the status quo and new mandatory disclosure, I urge the SEC to consider the "comply-or-explain" disclosure model widely adopted in other capital markets (and to a more limited extent within current U.S. rules) as a way to balance flexibility and consistency while alleviating compliance costs. [3] Private ordering will continue to help ESG reporting practices evolve, but in a world where investors, markets, and regulators themselves need investment-grade ESG information, it's time for the SEC to step up.

ENDNOTES

[1] Ernst & Young, Is Your Nonfinancial Performance Revealing the True Value of Your Business to Investors? (2017), at 6-7, http://www.ey.com/gl/en/industries/financial-services/fso-insights-is-your-non-financial-performance-revealing-the-true-value-of-business-to-investors; PWC, Sustainability Disclosures: Is Your Company Meeting Investor Expectations (July 2015), at 8, http://www.pwc.com/us/en/cfodirect/publications/in-the-loop/sustainability-disclosure-guidance-sasb.html.

[2] Sustainability Accounting Standards Board (SASB), The State of Disclosure 2016: An analysis of the effectiveness of sustainability disclosure in SEC filings (2016), at 8, https://library.sasb.org/state-of-disclosure-annual-report-2/.

[3] These arguments build on my prior work, which surveys empirical evidence on the effectiveness of comply-or-explain disclosure rules. See generally Virginia Harper Ho, "Comply or Explain" & the Future of Nonfinancial Reporting, 21 Lewis & Clark L. Rev. 317 (2017).

This post comes to us from Virginia Harper Ho, Associate Dean of International & Comparative Law and Professor of Law at the University of Kansas School of Law. It is based on her recent article, "Nonfinancial Risk Disclosure & the Costs of Private Ordering," available here and forthcoming in volume 55 of the American Business Law Journal (2018).

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