

To Our Clients and Friends

Memorandum

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Will the New SEC Guidance on Performance Metrics Impact Disclosure of ESG Metrics?

On January 30, the Securities and Exchange Commission (“SEC”) published new guidance (the “[Metrics Guidance](#)”) on key performance indicators and other metrics in the Management’s Discussion and Analysis (“MD&A”) sections of reports filed under the Securities Exchange Act of 1934 (the “Exchange Act”).¹ The Metrics Guidance provides that public companies disclosing metrics (whether financial or non-financial) in MD&A should consider whether additional disclosure is necessary to ensure that such metrics are not misleading, and further reminds companies to maintain disclosure controls and procedures with respect to such metrics. Although public reporting companies typically disclose environmental, social and governance (“ESG”) metrics in voluntary sustainability reports, some companies also disclose certain key ESG data in their Exchange Act filings. Companies that choose to disclose such ESG performance data in their MD&A should be mindful of the Metrics Guidance going forward.

Background on ESG Metrics and Sustainability Reporting

For years, investors have been advocating for public companies to disclose key ESG metrics in a manner that investors view as comparable, decision-useful and verifiable, whether in SEC filings (which many investors prefer due to the rigor associated with the SEC reporting process) or voluntary sustainability reports. All of the leading voluntary ESG frameworks, including those promulgated by the Sustainability Accounting Standards Board (“SASB”), the Global Reporting Initiative (“GRI”) and the Task Force on Climate-Related Financial Disclosures (“TCFD”), require disclosure of key ESG performance indicators and metrics. The SASB framework, in particular, was initially intended to be used in SEC filings, and encouraged inclusion of ESG disclosure in the MD&A.² Public companies, however, typically include their ESG disclosures in voluntary sustainability reports as opposed to their Exchange Act filings for a variety of reasons, including concerns regarding: (i) whether ESG metrics are material to an understanding of the company’s business and require disclosure; (ii) whether internal or external review of ESG metrics (e.g., by internal audit or disclosure teams) is adequate to make disclosure of such metrics “ready-for-prime-time” in SEC reports, (iii) the risk that inclusion of ESG metrics in Exchange Act reports would unnecessarily increase the financial and accounting burdens associated with periodic reporting, and (iv) heightened liability risk associated with disclosure of ESG metrics in materials filed under the Exchange

¹ Commission Guidance on Management’s Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33-10751; 34-88094 (Jan. 30, 2020).

² SASB has recently endorsed the use of its standards in communications (such as sustainability reports and corporate websites) other than SEC filings. See Tom Riesenbergs and Alan Beller, Sustainability Accounting Standards Board, Sustainability Accounting Standards and SEC Filings (June 5, 2019).

Act or incorporated by reference in registration statements filed under the Securities Act of 1933 (notwithstanding the fact that statements in voluntary sustainability reports have under some circumstances already been cited as grounds for general anti-fraud claims).³

Some investors and other stakeholders maintain that the absence of a mandatory disclosure regime has resulted in companies not providing easily comparable, decision-useful, and verifiable ESG data and metrics in their voluntary reports, opening companies up to accusations of “greenwashing.” However, to date the SEC has largely declined to mandate disclosure of line-item ESG metrics, and has instead confirmed support of a principles-based disclosure regime based on materiality. In proposed MD&A amendments also published by the SEC on January 30, the SEC makes no mention of ESG disclosure.⁴ Without mandated SEC disclosure of ESG metrics, many public reporting companies will continue to provide this disclosure in voluntary sustainability reports that are not filed as part of the Exchange Act record. However, those companies that do choose to report ESG performance metrics in their MD&A disclosure will be required to follow the Metrics Guidance.

Item 303(a) and the Metrics Guidance

Item 303(a) of Regulation S-K requires disclosure of information that a company believes is necessary to understand its financial condition, changes in financial condition and results of operation, and further requires discussion and analysis of statistical data that, in the company’s judgement, enhances a reader’s understanding of MD&A. In prior guidance and releases, the SEC has emphasized that, in preparing MD&A, companies should consider all key factors that management uses to manage the business that would be material to reasonable investors⁵, and should identify and address those key variables and qualitative and quantitative factors (i.e., key performance indicators and metrics) that are necessary for an evaluation of a specific company.⁶

The new Metrics Guidance reminds public companies that, when they include metrics in their MD&A disclosure, they should consider existing MD&A requirements and include material information necessary to avoid making the presentation of the metrics misleading under the circumstances. The SEC generally expects that the presentation would include: (i) clear definitions of metrics and how they are calculated (noting that changes in presentation or calculation from period to period may require additional disclosure regarding the changes), (ii) statements regarding the usefulness of the information to investors and (iii) statements regarding management’s use of the metrics in managing or monitoring performance. These requirements are largely consistent with certain current requirements for the presentation of non-GAAP

³ *Id.*; see also Tom Riesenbergh and Elisse Walter, Sustainability Accounting Standards Board, Sustainability and Liability Risk (Feb. 19, 2018); *In re Massey Energy Co. Sec. Litig.*, 883 F. Supp. 2d 597 (S.D. W. Va. 2012); *In re BP PLC Sec. Litig.*, 922 F. Supp. 2d 600 (S.D. Tex. 2013) (holding that statements in voluntary sustainability reports were actionable for purposes of stating a claim under Section 10(b) and Rule 10b-5 of the Exchange Act).

⁴ Management’s Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information, Release Nos. 33-10750; 34-88093 (Jan. 30, 2020).

⁵ See U.S. Sec. & Exchange Comm’n, Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operation, Release Nos. 33-8350 & 34-48960 (Dec. 19, 2003) [68 FR 75056 (Dec. 29, 2003) at 75056].

⁶ *Id.* (quoting Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Release No. 33-6835 (May 18, 1989) [54 FR 22427 (May 24, 1989)], which quotes Management’s Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-6349 (Sept. 28, 1981) [not published in the Federal Register]).

financial metrics by public companies. In addition, reporting companies should consider whether the disclosure of estimates or assumptions is necessary for the metric not to be materially misleading. Finally, the Metrics Guidance reminds reporting companies of the importance of maintaining effective disclosure controls and procedures when disclosing material key performance indicators or metrics.

Although the Metrics Guidance is largely silent with respect to ESG metrics as a specific category, it does note that some companies “voluntarily disclose environmental metrics, including metrics regarding the observed effect of prior events on their operations.” In a footnote, the Metrics Guidance provides examples of metrics to which the guidance is intended to apply, which include a number of ESG metrics, such as total energy consumed, percentage breakdown of workforce, voluntary and/or involuntary employee turnover rate and data security breaches.

While the Metrics Guidance addresses ESG metrics only via footnote, it is consistent with the recommendations in certain voluntary sustainability frameworks that require both qualitative and quantitative disclosure associated with ESG metrics. For example, SASB’s Conceptual Framework notes that sustainability metrics should be accompanied by “a narrative description of any material factors necessary to ensure completeness, accuracy, and comparability of the data reported.”⁷ In addition, the TCFD recommendations note that reporting companies should provide metrics on climate-related risks for historical periods to allow for trend analysis and, where not apparent, should provide a description of the methodologies used to calculate the climate metrics.⁸ Similarly, both SASB and TCFD emphasize the importance of having effective disclosure controls and governance, as well as verifying ESG data (by third-party auditors, if possible).⁹

Conclusion

The Metrics Guidance comes just in time for the 2020 10-K season. Public companies that include disclosure of ESG metrics in Exchange Act filings (whether voluntarily or because such metrics are considered to be material) during the current 10-K season and thereafter should be mindful of the Metrics Guidance, which becomes effective upon its publication in the Federal Register.

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⁷ See SASB Conceptual Framework (February 2017).

⁸ Task Force on Climate-Related Financial Disclosures, Final Report, Recommendations of the Task Force on Climate-Related Financial Disclosures (June 2017).

⁹ *Id.*; SASB Implementation Worksheet, Assessing Your Readiness (2020).

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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