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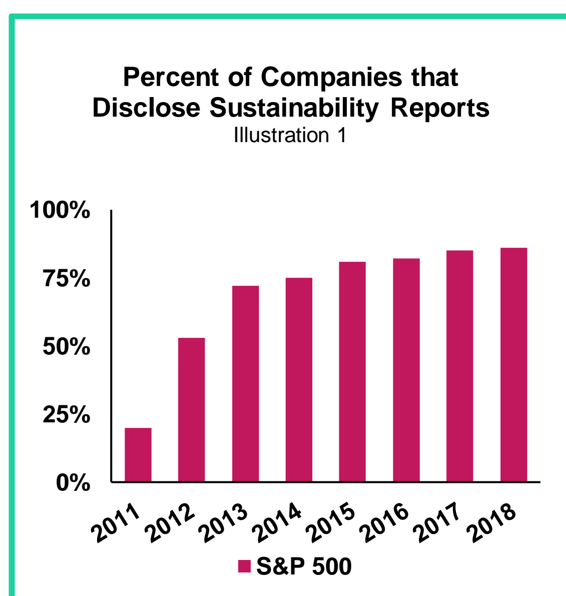
The Future of ESG Disclosures in the United States

An analysis of the impact of compliance and regulations of ESG disclosures in the United States

Introduction to ESG Disclosure

On the international stage, the United States is behind the curve in enacting regulation on ESG (environmental, social, governance) integration and disclosures. As regulatory requirements inevitably grow in the U.S., there are a number of implications and requirements that corporations will need to be prepared to comply with. In the last decade, there has been a global increase in companies voluntarily reporting their social and environmental performance, largely due to increased demand from investors and asset managers. In the United States, this trend is supported by the 86% of companies in the S&P 500 that have issued sustainability reports in 2018 compared to 20% in 2011.[1]



With this push, policymakers have put forth legislation to regulate this new market. The policy approaches vary by geographic regions; however, one commonality has been the need for ESG disclosures. The European Union has been paving the way forward on the regulatory front with specific directives while the U.S. have only begun to take preliminary action in Congress.

In this article, we review the global regulatory efforts to develop and implement standardized sustainable reporting. We take a deep dive into recent ESG-related regulations introduced in the U.S., and the challenges around policies and compliance in the current environment.

European Union: Paving the way

Early in the growth of ESG, the European Union (EU) was quick to adopt specific directives around ESG disclosures. Since 2014, European Directive 2014/95/EU states that 'public interest' companies of a certain size will be required to disclose environmental and social impact as part of the management report or in a separate document.[2] The law grants companies significant flexibility to choose their reporting framework whether international, EU or national guidelines. In addition, to ensure successful implementation across the EU Member States, the Directive allows state-specific requirements to define third-party verification and penalties for failure of adequate reporting.[3]

The Directive was groundbreaking, demanding a shift from voluntary to mandatory ESG disclosures. However, it was criticized by investors for not taking a stronger stance on standardization of reporting. As a result, in 2019 the Disclosure Regulation was adopted, requiring institutional investors and asset managers to disclose how they incorporate material sustainability risks in their decision-making processes.[4] The Directive and Regulations ensure that investors can make more informed investment decisions despite the lack of standardization in ESG disclosures.

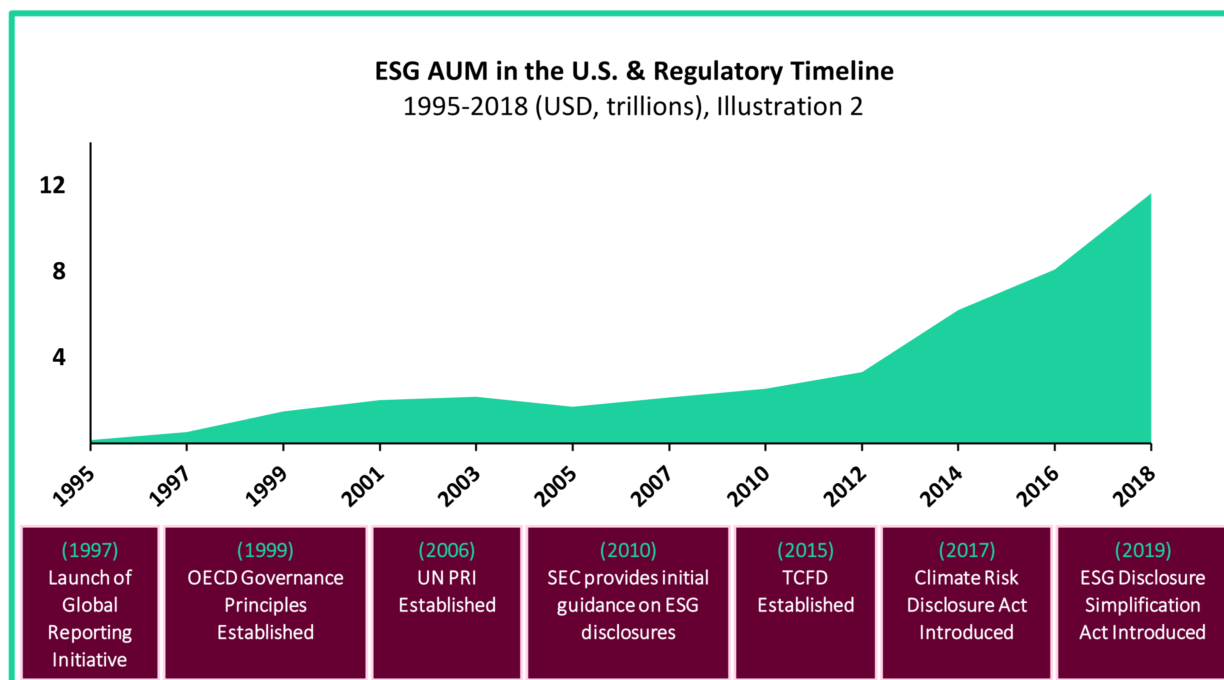
The EU has been an international leader on ESG disclosures, establishing the most comprehensive ESG framework through new and innovative regulations. By contrast, the U.S. Securities and Exchange Commission (SEC), which is responsible for enforcing federal securities law, has refused to amend existing laws or establish new regulations on ESG.[5] In the recent regulatory landscape, U.S. companies that operate in the EU will have to comply with the reporting requirements. These regulatory initiatives put forth in the EU may play a role in pushing forward similar regulatory requirements in the U.S.

[1] https://www.sustainability-reports.com/86-of-sp-500-index-companies-publish-sustainability-responsibility-reports-in-2018/
[2] https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en#relatedlinks
[3] https://www.globalreporting.org/resourcelibrary/NFRpublication%20online_version.pdf
[4] https://data.consilium.europa.eu/doc/document/PE-87-2019-INIT/en/pdf
[5] https://www.mondaq.com/unitedstates/securities/891760/sec-debate-on-climate-disclosure-regulation-gets-heated

US ESG Regulatory Trends

ESG Investing in the United States

ESG investing in the United States has seen a spike over the past 5 years. As ESG investing continues to develop, policymakers will develop additional regulatory requirements in order to monitor the industry. What was once a niche market has taken the forefront of the industry as investors and corporations become more conscientious of ESG metrics. In 1995, the total value of ESG assets under management (AUM) in the United States was $639 billion. By 2018, the total ESG AUM grew to $12 trillion, seeing a compound annual growth rate of 13.6%.[6]



Steps Forward from the SEC

Along with the growth of ESG funds in the U.S., significant steps have been made by the SEC and American policymakers. On October 1, 2018, a coalition composed of large public pension funds, asset managers, legal professionals, and non-profit organizations, filed a petition to the SEC demanding that they develop a comprehensive ESG framework.[7] The petition represented a growing interest and need for more standardized and developed frameworks around ESG from all corners of the investment industry.

Approximately one year after the petition was filed, in late 2019, the SEC's Office of Compliance Inspections and Examinations conducted an assessment of investment advisors on their ESG metrics. These examinations assessed topics such as: whether the adviser adheres to the UN Principles for Responsible Investing (UN PRI); what ESG investments have been made and sold; whether the adviser has its own or uses a third party's ESG scoring system and how the scoring methodology works.[8]

Shortly after these assessments, the SEC explicitly highlighted ESG factors as a priority in their examinations in their recently published *2020 Examinations Priorities*. They specifically outline their interest in the accuracy and adequacy of disclosures provided by registered investment advisors (RIAs) offering clients new types of emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate ESG criteria.[9]

With the recent and future growth of the ESG industry, it is expected that the SEC will maintain a focus on ESG funds through additional regulatory requirements and examinations.

[6]https://www.ussif.org/files/Trends/Trends%202018%20executive%20summary%20FINAL.pdf
[7]https://www.sec.gov/rules/petitions/2018/petn4-730.pdf
[8]https://www.jonesday.com/en/insights/2019/12/sec-scrutinizing-esg-funds
[9]https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf

ESG Disclosure Simplification Act of 2019

There is growing evidence of the materiality of ESG disclosures to investors internationally; as ESG metrics are examined and analyzed more in-depth, it has become increasingly clear that ESG metrics can be used to predict both reputational risk and financial performance.[10] In light of this correlation, investors have been demanding more comprehensive ESG disclosures from public companies. A 2019 survey was conducted in the US, Canada, Europe and Asia with respondents from all corners of the investment business. The study showed that over 70% of respondents worldwide adopted ESG as part of their investment approach. In the US, 65% of respondents claimed to leverage ESG in their decision-making.[11]

H.R. 4329 – ESG Disclosure Simplification Act of 2019

In September 2019, the Financial Services Committee introduced the ESG Disclosure Simplification Act (H.R. 4329) into the U.S. House of Representatives; it was the first-ever hearing in Congress addressing the integration of ESG factors into corporate decision making. The Act would require the SEC to enforce the publication of ESG disclosures of publicly traded corporations. There are two main mandates of the Act:

1. The SEC would be required to issue rules that define environmental, social, and governance (ESG) metrics and require that publicly traded companies disclose their views about those metrics and their long-term business strategy to their shareholders and the SEC annually.

2. The SEC would be required to establish a permanent sustainable finance advisory committee, composed of 20 members. In addition to their advisory duties to the Commission, the committee is also required to submit a report that (a) identifies the challenges and opportunities for investors associated with sustainable finance and (b) recommends policy changes to facilitate the flow of capital towards sustainable investments, in particular environmentally sustainable investments.

Source: US Congress.[12]

The implications of the ESG Disclosure Simplification Act (H.R. 4329) reach far beyond its requirements. Its hearing, which took place in mid-July of 2019, marked the first congressional hearing on ESG issues.[13] While the United Kingdom has already enforced a similar initiative with its launch of its first Green Finance Strategy, H.R. 4329 represents the long overdue regulatory requirements around ESG disclosures. This initial step forward is indicative of further ESG disclosure regulations to come in the U.S.

Across all public companies, there is a lack of standardized metrics and guidance around disclosures. During the initial hearing on H.R. 4329, potential frameworks were discussed to provide guidance on the standards for ESG disclosures. Of the various frameworks available, the Global Reporting Initiative (GRI) and the Carbon Disclosure Project (CDP) were discussed.[14] Should the ESG Disclosure Simplification Act be enacted, the SEC would need to establish a classification system similar to the EU that enables asset owners, asset managers, and other market participants to provide transparent data. Due to the lack of a standardized framework and the ambiguity in ESG disclosures, implicated companies from the Act will be susceptible to potential fines and lawsuits from their investors if their ESG disclosures do not meet the required standards outlined by the SEC.[15]

To address the lack of standardization in ESG disclosures globally, the *Better Alignment Project*, was initiated in 2018. It brought together a number of organizations such as the

[10] https://sia-partners.com/insights/how-does-coronavirus-global-pandemic-impact-sustainable-investment-revolution
[11] https://www.rbcgam.com/documents/en/other/esg-executive-summary.pdf
[12] *https://congress.gov/bill/116th-congress/house-bill/4329/text*
[13] https://www.greenbiz.com/article/us-congress-just-held-its-first-hearing-esg-issues-whats-next
[14] https://www.datamaran.com/blog/materiality-esg-us-congress/
[15] http://www.ilga.gov/legislation/publicacts/fulltext.asp?Name=101-0473&print=true&write=

CDP, GRI, the Climate Disclosure Standards Board (CDSB), the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB). The goal of the project is to align standards internationally with the recommendations published by the Task Force on Climate-related Financial Disclosures (TCFD).[16] Despite the initiative, the group asserts that companies need not delay their reporting, as the end goal is not a standardized framework, but a better alignment of understanding between reporting frameworks.[17] As ESG disclosures in the U.S. become a regulatory requirement, corporations may look to the *Better Alignment Project* to further understand the global framework around ESG disclosures.

Looking Forward

Sustainability reporting is no longer a supplementary option to appease demographics of millennial investors. Regulatory changes in Europe, APAC, and North America are being implemented towards the goal of international standardization of sustainability reporting. In the future, ESG disclosure compliance may become as commonplace as Basel IV or MiFID II. While the EU is at the forefront of this push forward in regulatory changes, the U.S. is starting to gain traction with its own regulatory oversight.

Although ESG disclosure compliance has gained tremendous international momentum, in the context of the United States, there are still challenges ahead. Even though more than 86% of the S&P 500 companies voluntarily disclose sustainability reporting, in 2019, the U.S. announced that it would be leaving the Paris Climate Agreement.[18] Another consideration is that the ESG Disclosure Simplification Act of 2019 is primarily a Democratic push sponsored by Representative Juan Vargas[19] which may be unlikely to pass a majority Republican Senate[20]. Regardless of whether the ESG Disclosure Simplification Act passes, it is a significant change in American discourse as it marked the first ever congressional hearing on ESG disclosure issues in the United States. Along with the international and domestic changes, American ESG disclosure legislation is inevitable.

Sia Partners has a long history of partnering with corporate leaders to establish their core business processes including strategy compliance, risk management and operational resiliency. Our expertise allows us to help you understand the coming changes of the latest ESG disclosure regulations. Sia Partners consultants are well-versed on the impact of international guidelines. Along with our professional credentials, Sia Partners has also launched *Consulting for Good,* our international initiative as a purpose-driven company which consists of three pillars: (a) Climate Centre Analysis, (b) Ethics and Compliance and (c) Social Responsibility. Contact us to start discussions on how we can help you with your ESG disclosures and sustainability initiatives.

[16] https://corporatereportingdialogue.com/better-alignment-project/#introduction
[17] https://corporatereportingdialogue.com/better-alignment-project/#introduction
[18] https://www.bbc.com/news/world-us-canada-50165596
[19] https://www.congress.gov/bill/116th-congress/house-bill/4329/text
[20] https://www.senate.gov/general/contact_information/senators_cfm.cfm

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