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You can’t get there from here: It’s time to *really* talk about ESG materiality

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Everyone is talking about ESG materiality. Materiality is one of the primary cornerstones of the U.S. securities laws and the disclosure regulations promulgated thereunder; it is at the foundation of many of the questions we come back to in the ESG context — what should we care about, to what degree should we care about it, and why? These also are the questions that shimmer at the edges of the aftermath of the SEC’s proposed climate change disclosure regulation, and they demand answers.

Materiality, in all its various forms, beats at the heart of the evolving ESG world. While traditionally regulatory developments, reporting requirements and common practice have provided at least a skeleton for what is and is not considered material, these points of reference have often been less helpful in the ESG context, where companies’ practices can vary as widely as their disclosures. And discussions of materiality in ESG disclosures have proliferated, as have the options and approaches to assessing it.

Has your company completed its materiality assessment, used the right materiality map, considered double materiality, nested materiality, or dynamic materiality? If you’re feeling materially confused, you’re probably not alone.

Even outside of the ESG context, determining materiality has always been part science and part art. While it is relatively easy to rattle off the definition established by the U.S. Supreme Court — information is material if there is a substantial likelihood that a reasonable investor would consider it important in making investment and voting decisions (herein “Material” or “Materiality”) — applying that definition is often significantly more complex.

There are very few bright-line Materiality rules in the U.S. federal securities laws, regulations and guidance, and traditionally the Supreme Court has explicitly declined to support bright-line tests in securities law cases when the opportunity has arisen. This means that companies and their counsel have to engage in an often intricate and iterative process of balancing the specific facts and circumstances to determine whether information or events are Material.

In the ESG context, the process of assessing Materiality may be made far more complex for at least three fundamental reasons. First, ESG is an evolving algorithm of values, engagements and considerations that most often exist outside of clearly articulated regulatory requirements. Matter of fact, arguably in order for ESG to be meaningful it must be changeable, functioning as a series of lenses for challenging the assumptions we make about what we value and how we measure value. And yet, accurately assessing Materiality is often aided by companies, or at least their counsel, being able to assess similar situations over time in order to determine what does, and does not, influence investor value.

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Because ESG involves an ever-evolving kaleidoscope of considerations, determining the Materiality of pure ESG considerations — including those pertaining to climate change-related and diversity-related matters — will always involve attempting to aim at where Materiality will be rather than where it necessarily is today. This can be an imperfect, messy process, and critically, it is not a process clearly considered or adopted by the U.S. Supreme Court when it established what Materiality means under the federal securities laws.

Second, ESG considerations may, and often do, fundamentally challenge the key assumption underlying the federal securities law definition of Materiality — specifically, the doctrine of shareholder primacy. Fundamental to ESG are two questions: (1) how should humans live, and (2) what does that mean for the purpose of the corporation, and specifically, do our answers to the first question mean that corporations should do more than create profit for their most direct owners?

It is often the proposition of ESG practitioners that ESG can and should function in the traditional context of the shareholder profit-making engine, and they are not wrong. ESG can function in that context; however, the unescapable reality is that the timelines in ESG are often longer than those traditionally conceived of in that said same engine. In the ESG context, we are often not dealing with a single lifetime; instead we are in the business of longer-term societal commitments to human survival, human rights and human dignity.

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Lastly, ESG has a data problem — actually, it has two. First, ESG involves matters that are fundamentally hard to measure. For example, measuring Scope 3 emissions currently still requires a level of estimates, assumptions and subjective determinations, which means the results often do not lend themselves to determinations regarding any definition of materiality, let alone the federal securities law definition, which would require that there be a substantial likelihood that a reasonable investor would consider Scope 3 emissions important in making investment and voting decisions.

In the wake of the SEC's proposed climate change disclosure regulation, it has become even more important for companies to actively address their Materiality determinations.

In this context, "reasonable" is doing a lot of heavy lifting — arguably a back-breaking amount of heavy lifting. Undoubtedly, Scope 3 emissions are a popular focus in the ESG world, and perhaps for good reasons under various definitions of materiality, including both double and dynamic materiality. But where this many estimates, assumptions and subjective determinations are required, "popular" likely should not be automatically read as "reasonable," and "material" under the definition of a voluntary framework likely should not be automatically read as rising to the level of Materiality under the federal securities laws.

Second, ESG involves matters where data is either not always readily accessible or is prohibitively expensive to acquire. Having already used the Scope 3 example, let's use the example of value chain considerations more broadly. Increasingly, companies are expected to have visibility and control over their third parties' ESG practices. Visibility to these matters is one thing — it requires that companies not only pursue detailed information (some of which is not always available), but also establish processes for determining the degree to which the data is accurate (in a space that, again, involves fundamentally hard to measure data).

However, control is something else entirely, and would require companies to put extensive processes in place to legally require and enforce third parties' compliance with detailed requirements. All of this means that, for certain ESG matters, many companies would have to spend much of their time gathering, assessing and verifying data in order to have a hope of determining Materiality, assuming that determining Materiality in that context was even possible.

In the wake of the SEC's proposed climate change disclosure regulation, it has become even more important for companies to actively address their Materiality determinations. As has been noted by others already, this Commission is paying close attention to how companies assess Materiality in the context of ESG matters, including climate change-related strategies, risks and goals. This attention has been made apparent through a number of speeches by SEC personnel, as well as through the SEC's current climate change disclosure comment letter process, which has often drilled down into companies' approaches to Materiality, and the Commission's proposed climate change disclosure regulation and other proposed ESG-related regulation.

Moreover, this Commission's approach to Materiality appears to be embracing, at a minimum, a level of dynamic materiality not clearly acknowledged by prior Commissions or by the U.S. Supreme Court. This is made evident in part by the Commission's reliance on the reporting framework promulgated by the Task Force on Climate-Related Financial Disclosures (TCFD) in its proposed climate disclosure rule, which is a framework that at least by implication relies on the concept of double materiality. In light of the Commission's newfound creativity in this regard, it has become increasingly important for companies to create their own certainty through consistency of approach.

For this reason, we often recommend that companies be very clear about which of five lenses of materiality are being used when creating disclosures, regardless of whether such disclosures are made voluntarily or in response to a regulatory regime. The five lenses of materiality are:

(1) How does the U.S. federal securities law definition of "Materiality" apply to the company's business, operations and financial statements, and what does that definition require in terms of disclosure?

(2) What is "material" to the company's specific stakeholders (i.e., investors, employees, customers, communities and business partners) — a definition that should not be confused with the "reasonable" investor standard of big "M" Materiality?

(3) What is "material" to the company, including with respect to how it wants to be viewed in the marketplace and compared to its peers and competitors?

(4) What external standards of materiality should apply to the specific area of disclosure (i.e., TCFD, SASB, GRI, etc.), including whether other jurisdictions' regulatory developments include different approaches to materiality? and

(5) With respect to each of the foregoing, how does Point A compare to Point B; in other words, how is materiality moving and what will it mean tomorrow (fundamentally, a concept of dynamic materiality)?

Note that only one of these definitions aligns to the current definition of Materiality under the federal securities laws, and in order for companies to create their own certainty around materiality they must now be very clear about what definition they are using and when.

There is no perfect path between the existing federal securities law definition of Materiality and a complete understanding and representation of ESG in corporate reporting. ESG presents us with a number of challenges, not the least or greatest of which is determining the aspects of it that may be Material for reporting purposes.

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However, we cannot shy away from addressing these challenges; we cannot ignore them or sweep them under the rug, either in the context of voluntary or required reporting. We must be brave because, if there is one thing that ESG demands, it demands our courage. Ultimately, only when we acknowledge the ways in which ESG challenges the status quo, including the ways in which it does and perhaps must function outside of the framework of the federal securities laws, can we find the best ways to address it.

About the author

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