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# Investor Interest in Nonfinancial Information: What Lawyers Need to Know

By Douglas Y. Park

More than ever before, investors want nonfinancial information from companies in making investment decisions. Examples of nonfinancial information (also referred to environmental, social, and governance or sustainability information) include climate change, water quality and quantity, ethical business practices, cybersecurity, and supply chain management. What environmental, social, and governance (ESG) risks does the company face? How is the company managing these risks? How is the company performing on corporate social responsibility (CSR) and sustainability factors relative to its industry peers? This article addresses the growing interest of investors in nonfinancial information and implications for lawyers in advising their clients.

Nonfinancial information has legal and business dimensions. On the legal side, a company may, as appropriate, be required to disclose nonfinancial information regarding climate change, cybersecurity, environmental impacts, and social impacts under state and federal regulations. How the company responds to these requirements can create liability consequences. On the business side, how a company implements and represents its CSR and sustainability practices may affect its operations, financial performance, corporate governance, and reputation. These business aspects of nonfinancial information can also raise questions for lawyers.

With this context, this article proceeds as follows. First, the article examines the rise of fiduciary capitalism and investor interest in nonfinancial information. Second, the article discusses the implications for lawyers. Finally, the article provides thoughts on the future of nonfinancial information.

## Institutional Investors and Nonfinancial Information

### *The Rise of Fiduciary Capitalism*

In the early 1930s, Adolf Berle and Gardiner Means described the modern corporation as one of dispersed ownership by small shareholders who had little power relative to managers. Before the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, investors had little information about the companies they invested in, or thought about investing in, because companies had to report little about themselves to investors. The Exchange Act gave investors a window into the financial condition and operations of a company by mandating that registered companies periodically report information to the Securities and Exchange Commission.

Since the passage of the Securities Acts, the capital markets have experienced eras of industrial or managerial capitalism and, more recently, finance capitalism, which was dominated by financial intermediaries such as banks, asset managers, and brokers. Some observers see the financial crisis of 2008 as the beginning of a new age – the age of fiduciary capitalism. Fiduciary capitalism differs from the other ages of capitalism in that long-term focused institutional investors dominate the capital markets. The primary actors in fiduciary capitalism are pension funds, university endowments, foundations, and sovereign wealth funds. John Rogers, "A New Era of Fiduciary Capitalism? Let's Hope So," *Financial Analysts Journal* (May/June 2014), Volume 70, Issue 3.

In the United States, these asset owners have common law fiduciary duties of care and loyalty. The duty of care, or prudence, requires the fiduciary to invest and manage the investments, diversification, and risks of the fund as a prudent investor would, considering the purposes, terms, and distribution requirements of the fund.

The duty of loyalty binds the investor to remain impartial between beneficiaries, for example, different generations. This duty may influence how the fiduciary incorporates nonfinancial information into its investment calculus:

> Given the potential for shifting of wealth, environmental remediation costs and climate risks between young and older generations, failures of fiduciaries to adopt a sustainable development investment approach has fiduciary duty implications and raises questions about the ability of fiduciaries to efficiently allocate investment capital to growth opportunities and manage risks to economic growth and future portfolio returns.

Keith Johnson, "Introduction to Institutional Investor Duties," *Institute for Sustainable Development Report*, pg. 8 (February 2014).

The Employees' Retirement Income Security Act's (ERISA) fiduciary standard applies to private pension funds. ERISA fiduciaries may not subordinate the economic interests of the plan to unrelated goals, and may not choose investments on factors other than the economic interests of the plan. Nonfinancial factors can be considered if they do not negatively affect risk and returns and if they are integrated into the financial and risk analysis to help choose an investment portfolio that meets the long-term investment objectives of the beneficiaries.

Although large, public pension funds are not subject to ERISA, they often follow the fiduciary standards of ERISA. The California Public Employees Retirement System (CalPERS), the largest public pension fund in the United States, explains how its sustainable investment approach supports its fiduciary duties:

> CalPERS' fiduciary duty is paramount to achieving our mission, which is to provide pension and health benefits to more than 1.6 million CalPERS members and their families. We clearly state that our focus is on the long term – which is both a responsibility and an advantage for a fund our size. . . . The Beliefs also elevate our framework for sustainable investment, recognizing that long-term value creation requires the effective management of three forms of capital: financial, physical, and human. This process has evolved our thinking on ESG issues into a core theme across our portfolio. The Beliefs flag important issues such as the multi-faceted nature of risk including climate change and resource availability, and the importance of managing costs.

CalPERS, *Towards Sustainable Investment & Operations: Making Progress, 2014 Report,* pg. 7 (2014).

The California State Teachers Retirement System (CalSTRS) requires its investment managers to assess ESG risks in making investments. CalSTRS explains why this approach is in its best interest:

> Since CalSTRS is a long-term investor and may hold an investment in a corporation or entity for decade after decade, short-term gains at the expense of long-term gains are not in the best interest of the Fund. Sustainable returns over long period are in the economic interest of the Fund.

CalSTRS, *Teachers' Retirement Board Policy Manual*, pg. A-18 (2013).

### *Materiality and Investor Interest in Nonfinancial Information: The NRDC Cases*

Materiality is intrinsically tied to the reasonable investor. After all, what is material depends on what the reasonable investor would find important in his or her investment decisions. Yet, courts have not explicitly or clearly defined the reasonable investor. Instead, courts have attributed a number of traits to the reasonable investor, including rationality in investment decision making. (Tom C.W. Lin, "The New Investor," 60 *UCLA L. Rev.* 678, 694–695 (2013)). Although the definition of the reasonable investor is not settled, the definition is intended to be objective. (Stephen Padfield, "Is Puffery Material to Investors? Maybe We Should Ask Them," 10 *U. Ap. J. Bus. & Emp. L.* 339, 346, 365 (2008). The SEC explains that the reasonable investor has been viewed as a long-term investor going back to the Exchange Act. Regulation NMS, 70 Fed. Reg. 37,496, 37,500 (June 29, 2005).

Through a series of cases brought by the National Resources Defense Council (NRDC) against the SEC during the 1970s, the SEC provided insight how it thinks about the reasonable investor. The late 1960s and early 1970s saw shareholders and organizations ask companies to disclose more social, environmental, and civil rights information. For example, Campaign GM was a proxy proposal that involved General Motors shareholders asking the company to provide more information on its environmental and civil rights performance and on safety and design issues. In 1971, the NRDC brought a rule-making petition before the SEC, asking the commission to expand civil rights and environmental disclosure under the federal securities laws. *NRDC v. SEC*, 389 F. Supp. 689, 693–694 (D.D.C. 1974). After a number of investigations and public hearings spanning almost a decade, the SEC decided in administrative proceedings that the requested disclosures were not needed because only a small fraction of investors considered social and environmental information important. Two federal courts upheld the SEC's rule-making authority and actions.

The district court ordered the SEC to work on two critical factual issues regarding materiality: first, the prevalence of ethical investor interest in greater environmental and civil rights disclosure, and second, what other avenues ethical investors can use to combat corporate actions that negatively affect the environment or the practice of equal employment. Regarding expanded social disclosure, the SEC found that about 0.0005 percent of the total value of stocks and bonds in the United States in 1974 was invested using ethical investing principles. Likewise, shareholder proposals on environmental and social received, on average, between 2 percent to 3 percent approval during the 1970s. These findings led the SEC to conclude that ethical investing was not an important or significant type of investing. Commission Conclusions and

Rule Making Proposals, Securities Act Release No. 5627, Exchange Act Release No. 11773, [1965–1976 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 80, 820 at 85,719-720 (Oct. 14, 1975).

The SEC's decision turned on a level of interest insufficient to conclude that the reasonable investor was interested in social and environmental information. The commission's analysis of what is material to the reasonable investor depended, to a large extent, on the portion of investors and assets under management interested in nonfinancial information. This suggests that when a sufficiently large percentage of investors and/or assets under management consider sustainability information to be material, sustainability disclosure would be justified because the reasonable investor views that information as decision-useful.

Because investors presumably invest primarily for economic gain, the commission decided to adhere to an economic understanding of materiality. Further, the SEC stated that it could not require disclosure solely for the purposes of changing corporate behavior, although it recognized that disclosure might have an indirect effect on such behavior. To require disclosure solely for the goal of changing corporate behavior would go beyond the commission's authority to require disclosure that is "necessary or appropriate for the protection of investors or the furtherance of fair, orderly and efficient markets or for fair opportunity of corporate suffrage." (Commission Conclusions, Securities Act Release No. 5627, at 85,713.) This reasoning, however, contradicts the legislative intent of the Securities Acts. Moreover, expanded social and environmental disclosure can provide useful information to investors that directly relates to the goals of investor protection and informed voting. Cynthia A. Williams, "The Securities and Exchange Commission and Corporate Social Transparency," 112 *Harvard L. Rev.* 1197, 1272-1273 (1999).

### *Increased Investor Interest in Nonfinancial Information Today*

The level of investor interest in nonfinancial information has dramatically increased since the SEC's market study of the 1970s. One reason is the growth of sustainable, responsible, and impact investing. According to US SIF (The Forum for Sustainable and Responsible Investment), at the beginning of 2014 approximately $6.57 trillion in assets under management was engaged in sustainable, responsible, and impact investing. This amount represents about 18 percent of the $36.8 trillion in total assets under management in the United States. The amount invested in sustainable investing practices increased 76 percent from $3.74 trillion in 2012. Since 1995, when US SIF first began tracking sustainable, responsible, and impact investing, the amount of assets engaged in this investment approach has increased over 900 percent from about $600 billion. *Report on US Sustainable, Responsible and Impact Investing Trends 2014*, US SIF, pg. 12–16 (2014).

In response to a 2013 survey conducted by Ernst & Young of more than 160 investors, analysts, and portfolio managers around the globe, nine out of 10 respondents stated that nonfinancial performance had played a pivotal role in their investment decision-making in the past 12 months. The report concluded: "This demonstrates that the analysis of nonfinancial issues can no longer be dismissed as a niche approach to investment." EY, *Tomorrow's Investment Rules: Global Survey of Institutional Investors on Non-Financial Performance* (2014).

How do investors benefit from nonfinancial information? In response to PwC's survey in 2014 of institutional investors with $7.6 trillion in assets under management, 73 percent said that risk mitigation is the primary reason they consider sustainability information. Fifty-five percent said that avoiding unethical companies is a reason for their interest, and 52 percent said that financial performance is why they factor sustainability information into their investment decisions.

Despite investor interest in nonfinancial information, companies are not providing the information that investors want. Sixty-one percent of investors stated that they are dissatisfied with corporate disclosures of social and environmental information by U.S. companies. With respect to sustainability issues, investors expressed broad dissatisfaction with how U.S.-listed companies are disclosing information:

- 79 percent are dissatisfied with comparability of sustainability reporting between companies in the same industry.
- 74 percent are dissatisfied with relevance and implications of sustainability risks.
- 68 percent are dissatisfied with sustainability strategy that is linked to business strategy.
- 62 percent are dissatisfied with internal governance of sustainability issues.
- 57 percent are dissatisfied with process used to identify material sustainability issues.

PwC, *Sustainability Goes Mainstream: Insights Into Investor Views* (May 2014).

Another reason for the increased interest in nonfinancial information is the greater presence of long-term oriented institutional investors today. Institutional investors own 70 percent of the largest 1,000 U.S. companies, and pension funds own almost 40 percent of this amount. Institutional investors incorporate sustainable, responsible, and impact principles into investment analysis and portfolio selection of $4.04 trillion, or about 60 percent of the total amount of assets under management investing using these principles.

At the same time, a growing number of investors has committed to the United Nations Principles for Responsible Investment (PRI). The PRI is a global framework for investors to include ESG information into investment analysis and decisions with the purpose of increasing returns and reducing risk. In 2009, 560 institutional investors with $18 trillion in assets under management had committed to the principles, while in 2014 over 1,200 investors with $34 trillion in assets under management had done so. The principles are based on the idea that ESG issues can affect investment performance and that consideration of these issues can help to produce superior risk-adjusted returns. For these reasons, nonfinancial information can fall squarely within investors' fiduciary duties. The principles explicitly state they are to be applied only in a manner that is consistent with those duties.

In incorporating ESG information into fundamental equity analysis, investors use the information in several ways:

- Economic analysis: To understand industry trends and externalities likely to affect the economic outlook and, therefore, value creation and capital formation.
- Industry analysis: To understand factors driving competitiveness and the potential for sustained value creation in an industry, as well as externalities from an industry likely to affect other industries (and therefore portfolio risks).
- Company strategy: To understand management quality and corporate strategy, and evaluate a company's ability to respond to emerging trends.
- Valuation: To adjust traditional valuation parameters and assumptions, including cash flow and weighted average cost of capital, to reflect performance on material sustainability issues.

Robert C. Eccles and Jean Rogers, *The SEC and Capital Markets in the 21st Century: Evolving Accounting Infrastructure for Today's World,* Governance Studies at Brookings, pg. 5 (Sept. 2014).

### Implications for Lawyers

The trend of increasing investor interest in nonfinancial information has many implications for how lawyers might advise their clients. With respect to disclosing nonfinancial information to investors, lawyers will need to consider how to advise companies on what kind of information to provide, in what level of detail, and in what format. Should the company provide information only on ESG issues that investors specifically ask about? Should the company provide information on the commonly sought types of information (e.g., climate change) for companies in its industry? How much information and at what level of detail (general initiatives or measurable performance) is enough to satisfy investors? Should the information be provided in voluntary sustainability reports or in SEC filings? A company may, under appropriate circumstances, need to disclose information on these issues in a company's SEC filings under Regulation S-K. In other situations, a company may decide to report the information in voluntary reports, such as its corporate social responsibility, Global Reporting Initiative, or sustainability reports.

Since nonfinancial information is related to risk mitigation and value creation, the lawyer should consider reviewing the board's role in overseeing the information. What kind of nonfinancial information, and how much, should management report to the board? Should an existing or dedicated committee be responsible for the oversight of nonfinancial information? Or should the entire board be responsible? Should the compensation of executives be tied to performance on nonfinancial matters? If so, over how long of a time period?

Finally, lawyers can help clients understand the liability implications of nonfinancial information. Companies that fail to disclose material sustainability information may face a higher risk of shareholder suits alleging that the company made materially misleading or false statements. Companies who consider disclosing nonfinancial information in SEC filings should examine the requirements and potential liabilities associated with signing Section 302 and 906 Sarbanes-Oxley certifications concerning the company's disclosure controls and procedures. Lawyers can help companies assess the materiality of sustainability information and evaluate the risks of disclosing, or not disclosing, sustainability information.

### Conclusion

With the growing prominence of fiduciary capitalism, nonfinancial information assumes greater significance for companies and investors. Investors want nonfinancial information that will help them reduce risk, improve returns, and make better informed investment decisions. How can they obtain the information in an effective, efficient manner that allows them to compare companies within industries? Companies need to find a way to address investor demand for nonfinancial information. How can companies collect, organize, and report information to investors in a cost-effective manner?

So long as fiduciary investors manage a substantial portion of assets under management, nonfinancial information is likely to remain important to the efficient operation of the capital markets and the formation of capital. Lawyers can play a critical role in advising companies and investors about the legal and business implications of nonfinancial information.

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