"COMPLY OR EXPLAIN" AND THE FUTURE OF NONFINANCIAL REPORTING

by
*Virginia Harper Ho**

Although investor demand for material "environmental, social, and governance" (ESG) information that can be readily used in financial analysis continues to grow, many firms and their advisors have concerns about the potential costs and benefits of new disclosure mandates. This Article argues that a "comply-or-explain" approach to ESG reporting could be a more effective alternative to new line-item mandates on the one hand, and reliance on voluntary ESG reporting on the other.

This Article first surveys empirical research across many of the jurisdictions that have implemented a comply-or-explain approach and finds that comply-or-explain principles have proven effective in improving corporate governance practices and enhancing corporate transparency, particularly in the markets that most resemble the United States. It then draws on this comparative experience to propose principles that could guide the Securities and Exchange Commission in incorporating a comply-or-explain approach to ESG reporting within the current U.S. financial reporting framework. It concludes by suggesting specific elements that could be incorporated in new ESG disclosure standards on a comply-or-explain basis.

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* Professor, University of Kansas School of Law. This Article benefitted immensely from the insights of the Symposium attendees and presenters.

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I. INTRODUCTION

Over the past decade, a growing number of securities regulators and stock exchanges worldwide have acknowledged that information on companies' nonfinancial or "environmental, social and governance" ("ESG") performance and risk may be material to investors and to the stability of modern capital markets.[1] Over 60 jurisdictions on every continent, including all of the members of the G20, now require or encourage corporate disclosure of ESG issues in some form, and a majority now do so through financial regulation, corporate law, or stock exchange listing rules rather than through environmental regulation or other agency mandates.[2] In the U.S., evidence of growing attention to ESG issues in-

[1] The term "ESG" extends beyond these three dimensions and refers broadly to a range of nonfinancial information that reflects business and strategic risk and the corporation's impacts on its key stakeholders and sources of capital. The CFA Institute defines ESG issues as the "environmental, social, and governance issues that Investors are considering in the context of corporate behavior. Often these ESG issues have been considered nonfinancial or nonquantifiable in nature and have a medium- to long-term time frame in their effect on a Company." CFA Inst. Ctr. for Fin. Mkt. Integrity, Environmental, Social and Governance Factors at Listed Companies: A Manual for Investors 22 (2008); *see also* Jane Gleeson-White, Six Capitals, or Can Accountants Save the Planet? (2015) (conceptualizing natural and human resources as capital for value creation by the firm).

[2] *See* Wim Bartels et al., KPMG Int'l et al., Carrots & Sticks: Global Trends in Sustainability Reporting Regulation and Policy 10, 14 (2016) (reporting that one-third of the nearly 400 sustainability guidelines or instruments globally have been introduced by financial regulators or stock exchanges); Hauser Inst. for Civil Soc'y, Corporate Social Responsibility Disclosure Efforts by National Governments and Stock Exchanges (2015); *Sustainability Reporting Policies—2012*, Sustainable Stock Exchs. Initiative, http://www.sseinitiative.org/data/sustainabilityreporting/; Céline Kauffmann et al., *Corporate Greenhouse Gas Emission Reporting: A Stocktaking of Government Schemes* 13–19 (OECD Publ'g, Working Paper on Int'l Investment 2012/01). Precisely which firms are covered by the

cludes guidance issued by the Securities and Exchange Commission (SEC) in 2010 on the materiality of climate change risk,[3] as well as the hotly contested conflict minerals reporting rules and other "specialized disclosures" mandated by the Dodd-Frank Act.[4] In 2016, the SEC also sought comment on the approach it should take toward ESG and risk-related reporting generally as part of its comprehensive review of the current reporting obligations for public companies.[5]

Although many capital markets are moving increasingly toward mandatory ESG reporting,[6] the SEC has adopted a more cautious approach to ESG disclosure. This hesitation is due in part to deep concerns among the business community and the bar about the potential cost and legal risk associated with new disclosure mandates, as well as continued skepticism toward the mounting empirical evidence of the financial materiality of many ESG factors to firms and to investors.[7] In addition, current federal reporting rules already require listed firms to disclose some forms of ESG information, and companies are also obligated to disclose other material information if it is necessary to comply with the general antifraud requirements of the securities laws.[8] Investors and other stakeholders can also obtain ESG information that companies disclose in voluntary sustainability or corporate social responsibility (CSR) reporting. By some measures, this market-based approach, driven by consumer, NGO, and shareholder pressure, rather than federal securities regulation

reporting rules varies by jurisdiction. *See* SUSTAINABLE STOCK EXCHS. INITIATIVE, 2014 REPORT ON PROGRESS 14–19 (2014) (detailing the requirements across jurisdictions).

[3] Commission Guidance Regarding Disclosure Related to Climate Change, 75 Fed. Reg. 6290 (Feb. 8, 2010) [hereinafter 2010 Climate Guidance].

[4] *See* SUSTAINABLE STOCK EXCHS. INITIATIVE, MODEL GUIDANCE ON REPORTING ESG INFORMATION TO INVESTORS (2015); *see also infra* Part II.A (discussing specialized disclosure requirements). The New York Stock Exchange and the Nasdaq are also partners of the Sustainable Stock Exchanges Initiative, which has encouraged stock exchanges to integrate ESG factors into their disclosure guidance for listed firms. *List of Partner Exchanges*, SUSTAINABLE STOCK EXCHS. INITIATIVE, http://www.sseinitiative.org/sse-partner-exchanges/list-of-partner-exchanges/.

[5] Business and Financial Disclosure Required by Regulation S-K: Concept Release, 81 Fed. Reg. 23,916 (Apr. 22, 2016) [hereinafter Concept Release].

[6] Most of the ESG disclosure measures adopted by G20 governments within corporate, securities, and financial regulation to date are mandatory, some after a period of voluntary transition. *See* BARTELS ET AL., *supra* note 2, at 12 (reporting that about two-thirds of all sustainability guidelines or instruments globally, including those issued by other government agencies, are mandatory).

[7] *See* Business Roundtable, *Principles of Corporate Governance*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE & FIN. REG (Sept. 8, 2016), https://corpgov.law.harvard.edu/2016/09/08/principles-of-corporate-governance/ (taking the position that investors who integrate environmental or social issues into investment strategy must be doing so solely to advance "social agendas unrelated and/or immaterial to the company's business strategy").

[8] *See infra* Part II.A.

or stock exchange listing rules, has worked: over 80% of Fortune 500 firms in the U.S. now produce a CSR or sustainability report.[9]

However, the current state of ESG reporting is satisfactory to almost no one. Investors require information that is timely, reliable, consistent, and comparable among firms and over time, but voluntary reporting does not meet this standard and cannot be readily integrated with financial reporting.[10] Still, firms are expending significant resources on producing CSR or ESG reports that they make available to investors as well as to the broader public. Those that do so are confronted by a vast array of reporting frameworks, competing investor demands, and uncertain legal risks associated with ESG disclosures. The disconnect between mandatory financial reporting and voluntary ESG reporting renders the two less comparable to investors and has, for many firms, resulted in more costly and less efficient reporting, often through separate units and reporting structures.

As investor demand for ESG information that can be readily used in financial analysis continues to grow, the SEC must decide whether to maintain the status quo or to affirmatively facilitate better ESG disclosure in some form. Again, the choice is not whether listed firms should produce ESG disclosures or not—they already do—but whether regulators should take steps to improve the quality, accessibility, and comparability of that information for investors and if so, then how. If, as the evidence now seems to show, many ESG indicators are financially material,[11] the limited utility of current voluntary reporting for financial analysis and the strong reservations many firms and their advisors have about the potential costs and benefits of mandatory disclosure rules mean that new approaches to ESG disclosure beyond a simplistic voluntary-mandatory choice are clearly necessary.

I argue that the SEC should consider a "comply-or-explain" approach to ESG reporting. Comply-or-explain principles were first introduced in the United Kingdom in the 1990s as the core of its corporate governance reforms, and have since been adopted around the world.[12]

[9] *See Eighty-One Percent (81%) of the S&P 500 Index Companies Published Corporate Sustainability Reports in 2015*, GOVERNANCE & ACCOUNTABILITY INST. (Mar. 15, 2016), http://www.ga-institute.com/nc/issue-master-system/news-details/article/flash-report-eighty-one-percent-81-of-the-sp-500-index-companies-published-corporate-sustainabi.html.

[10] *See infra* Part II.C (describing these limits); *see also* TASK FORCE ON CLIMATE-RELATED FIN. DISCLOSURES (TCFD), PHASE I REPORT OF THE TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES 8–9 (Mar. 31, 2016) (describing the deficiencies of climate-related risk disclosures and reporting frameworks).

[11] On ESG materiality, see *infra* note 17 and accompanying text.

[12] *See* REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (Dec. 1992), http://www.ecgi.org/codes/documents/cadbury.pdf. Also known as the Cadbury Report, it has since been incorporated in the 2003 and more recent 2006 amendments to the U.K. Companies Act. *See* Companies Act 2006 c. 46, § 13 (Eng.).

Under the comply-or-explain model, a securities regulator, stock exchange, or other authority adopts a code reflecting corporate best practices. Companies can then elect to comply with the new rules in one of two ways: either by implementing the codes' provisions directly or by providing an explanation for why they have elected not to follow them. Under a comply-or-explain regime, only a firm that both fails to implement the code's best practices *and* fails to provide an adequate explanation would be noncompliant. Although comply or explain is not without criticism, regulators outside the United States have widely embraced comply-or-explain principles as a self-regulatory approach to both corporate governance and ESG transparency.[13] Indeed, several provisions of current U.S. reporting requirements already follow a comply-or-explain approach, offering some precedent for a new model of ESG reporting.[14]

This Article opens by exploring ESG's financial relevance to firms, investors, and regulators, identifying the particular challenges ESG reporting poses, and introducing current approaches to ESG reporting in the U.S. and in other jurisdictions. It then surveys empirical research across many of the jurisdictions that have implemented a comply-or-explain approach in order to assess how well comply-or-explain models have worked. This survey indicates that comply-or-explain principles have proven effective in improving corporate governance practices and enhancing corporate transparency, particularly in the markets that most resemble the United States. The final Part of the Article draws on this comparative experience to propose principles that could guide the SEC in incorporating a comply-or-explain approach to ESG reporting within the current financial reporting framework. The argument here is not that comply or explain should be the SEC's sole approach to ESG disclosure, but that it could be a more effective alternative to new line-item mandates and continued reliance on voluntary ESG reporting. Because the choice of a comply-or-explain model still leaves open a range of policy choices with regard to the appropriate scale and scope of disclosure, this Article concludes by suggesting specific elements that could be incorporated in new ESG disclosure standards.

II. ESG REPORTING: AN OVERVIEW

Current debates about the future of ESG reporting and the role the SEC should play are arising in the context of a major shift in investor demand for ESG information that is now already well underway.[15] ESG

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[13] *See infra* Part III.B (discussing findings from empirical studies).

[14] *See id.* (discussing these examples).

[15] These debates are reflected in the diversity of views expressed by investors, firms, and legal commentators to the SEC's 2016 Concept Release, *supra* note 5. *See also* U.S. SEC. & EXCHANGE COMM'N, Comments on Concept Release: Business and

issues have long been thought to be of interest to investors primarily as a matter of public policy or social concern, and ESG disclosure has historically been driven by consumer advocacy, nongovernmental organizations, and the early "social" or "responsible" investor movement. Now, however, financial institutions who see companies' ESG performance as directly tied to investment risk and return across asset classes manage over half of all public debt and equity globally.[16] These strategies are supported by evidence from over two thousand studies that, taken together, establish the financial materiality of many ESG factors to firm and portfolio risk and return.[17] Credit-rating agencies, accounting firms, and many financial analysts and investment advisors are developing new tools to help investors assess how well firms incorporate ESG information into business strategy, risk management, corporate governance, and value creation.[18] Financial regulators have also voiced concern about the potential systemic impact of ESG risks on the stability and long-term sustainability of global capital markets.[19]

However, a key challenge for governments considering the appropriate scope of any ESG disclosure guidance or new reporting rules is the sheer range of issues that are potentially material to investors. Empirical

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Financial Disclosure Required by Regulation S-K, https://www.sec.gov/comments/s7-06-16/s70616.htm.

[16] *See Signatory Base AUM Hits $59 Trillion*, PRINCIPLES FOR RESPONSIBLE INV. (June 2, 2015), https://www.unpri.org/page/signatory-base-aum-hits-59-trillion (reporting that this figure, current as of April 2015, represents over half of all institutional assets globally, including public debt and equity, and a 29% average annual increase since 2006).

[17] GORDON L. CLARK ET AL., FROM THE STOCKHOLDER TO THE STAKEHOLDER: HOW SUSTAINABILITY CAN DRIVE FINANCIAL OUTPERFORMANCE (Mar. 2015), http://www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11.; Gunnar Friede et al., *ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies*, 5 J. SUSTAINABLE FIN. 210 (2015); *see also* Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 665–68 (2016) (reviewing this literature). The Department of Labor's 2015 guidance for investment fiduciaries also recognizes that environmental and social indicators may be directly relevant to the economic value of an investment. Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 65,135, 65,136 (Oct. 26, 2015).

[18] *See, e.g.*, S&P GLOB. RATINGS, RATINGSDIRECT: PROPOSAL FOR ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) ASSESSMENTS 2 (Sept. 5, 2016), http://www.eticanews.it/wp-content/uploads/2016/09/SP-Global-Ratings-Proposal-For-ESG-Assessments_Sept20162.pdf.

[19] The Financial Stability Board, which coordinates financial sector policy-making by central banks and international financial institutions and standard-setters, has identified climate change as a source of systemic risk to the global financial system and is developing voluntary disclosure principles and guidelines to improve the quality and usefulness of climate change-related financial reporting. *See* TCFD, *supra* note 10, at 3; *About the Task Force*, TASK FORCE ON CLIMATE-RELATED FIN. DISCLOSURES, https://www.fsb-tcfd.org/about/.

evidence supports the financial materiality of positive and negative ESG indicators broadly, but does not identify particular indicators that are material to all firms or to all investors.[20] Instead, the evidence suggests that financial materiality varies by industry sector and that the materiality of many ESG indicators only becomes clear in the medium- to long-term.[21] Since financial reporting in the U.S. and most other jurisdictions already includes disclosures on many aspects of corporate governance, the debate over the materiality of ESG disclosure tends to focus more heavily on environmental or social issues, despite the increasingly blurred lines between these two categories. However, the fact that voluntary ESG disclosure initiatives link governance to other ESG factors allows investors and firms to claim strong support for ESG investment strategies or disclosure rules that in fact look quite conventional in their consideration of corporate governance but give very little weight to "E" or "S" factors.

As the SEC weighs the evidence on ESG materiality and considers whether more explicit requirements for ESG disclosure are necessary to promote federal regulatory goals, another primary challenge is that neither the SEC nor its counterparts worldwide are working from a blank slate. Any new regulatory approach to ESG disclosure must therefore take account of multiple overlapping and often divergent disclosure frameworks that contribute to the current complexity of ESG reporting.

A. *Mandatory Reporting*

In the U.S. and many other jurisdictions, some form of public reporting on environmental, labor, or human rights practices is required by relevant governmental agencies for purposes of advancing their regulatory mission. For example, in the U.S., firms must establish monitoring and reporting systems to comply with anti-bribery regulations under the Foreign Corrupt Practices Act (FCPA),[22] and the Environmental Protection Agency (EPA) enforces various reporting requirements as a matter of environmental regulation and permit enforcement.[23] In 2009, the EPA also introduced greenhouse gas (GHG) disclosure requirements that apply to certain large emitters.[24] These regulatory disclosures and public data on regulatory enforcement actions are important sources of infor-

[20] *See* Harper Ho, *supra* note 17, at 662–74 (reviewing this literature).

[21] *See* Mozaffar Khan et al., *Corporate Sustainability: First Evidence on Materiality*, 91 ACCT. REV. 1697, 1698–1703 (2016) (assessing the materiality of indicators developed by the Sustainability Accounting Standards Board (SASB)).

[22] *See, e.g.*, 15 U.S.C. §§ 78dd-1, 78m (2012).

[23] *See, e.g.*, 40 C.F.R. § 704 (2016).

[24] *Id.* § 98.

mation on ESG risk trends, but many investors have difficulty integrating this information into investment analysis.[25]

In the United States, financial reporting rules for public companies reflect a hodgepodge approach to ESG issues. In general, a number of reporting rules under the securities laws, particularly those related to business strategy and risk management, already apply to material ESG risks and impacts, and most are not subject to quantitative materiality thresholds. For example, ESG factors are often associated with business risk, including legal, regulatory, and reputational risk, and are also leading indicators of financial and market risk subject to disclosure under Item 305 of Regulation S-K.[26] Required disclosures on internal financial controls and procedures, the board's role in risk oversight, and the relationship between the company's risk management policies and procedures and executive compensation all potentially encompass ESG policy and practice or address material ESG risks.[27] In addition, although issuers of securities are not required to disclose *all* material information,[28] they must go beyond specific line-item reporting requirements to disclose "such further *material* information . . . as may be necessary to make the required statements, in light of the circumstances . . . not misleading."[29] Under the Supreme Court's standard established in *TSC Industries*, information is material if there "is a substantial likelihood that a reasonable

[25] *See* Kauffmann et al., *supra* note 2 at 32–33 (tracing deficiencies in investor use of climate disclosure more directly to broader challenges, including the limits of voluntary reporting and investor short-termism). An example of the lack of integration of regulatory and financial disclosure is that mine safety disclosures required under § 1503 of the Dodd-Frank Act essentially required disclosure in annual reports of regulatory notifications and safety-related penalties already imposed under existing law. *See infra* note 35.

[26] SEC Regulation S-K, 17 C.F.R. § 229.305 (2016) (requiring quantitative and qualitative disclosures of material market risk exposure).

[27] Disclosures on internal financial controls, introduced under Sarbanes-Oxley, are required under Items 307 and 308 of Regulation S-K. 17 C.F.R. §§ 229.307–308. Item 402(s) requires registrants to provide a narrative discussion of how its compensation policies relate to risk management practices and risk-taking incentives if risks arising from those policies and practices are "reasonably likely to have a material adverse effect" on the company. 17 C.F.R. § 229.402(s). Item 407 and related requirements under the proxy rules address the board's role in risk oversight and the implementation and effectiveness of any diversity policy for board nominations. 17 C.F.R. § 229.407(c)(2)(vi), (h); Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,366–67 (Dec. 23, 2009) (amending SEC forms N–1A, N–2, N–3 to require disclosure of board's role in risk oversight).

[28] *See In re* Time Warner Sec. Litig., 9 F.3d 259, 267 (2d Cir. 1993) ("[A] corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact. Rather, an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts.").

[29] 17 C.F.R. § 230.408 (emphasis added); General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.12b–20 (emphasis added).

shareholder would consider it important in deciding how to vote" or "that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information" available to the investor in reaching a voting or investment decision.[30] These standards place an affirmative obligation on issuers to disclose additional material ESG issues that may not be identified expressly in the disclosure rules.

In its 2010 guidance on the materiality of climate-related risk, the SEC identified many of the reporting rules under Regulation S-K that potentially include the material effects of climate change on issuers themselves. For example, the general description of the business in Item 101 of Regulation S-K may encompass material changes in operations that result from ESG risks or opportunities, and Item 101(c) "expressly requires disclosure [in the Form 10-K report] regarding certain costs of complying with environmental laws."[31] The 2010 Guidance notes further that Item 103 requires companies to "briefly describe any material pending [or contemplated] legal proceedings,"[32] and Item 503 requires disclosure of risk factors affecting the company's equity.[33] Item 303's Management Discussion and Analysis (MD&A) also requires discussion of "any known trends or uncertainties" that the firm "reasonably expects" to have a material impact on the firm's financial condition or operating performance.[34]

Beyond these requirements, the SEC has also adopted a number of specialized disclosures under direct authorization from Congress, and certain ESG disclosures are now mandated under state law. Federal specialized disclosure rules require all companies to report on the use of conflict minerals in their supply chain and companies in the extractive sector to report on mine safety and payments to U.S. and foreign governments.[35] More recent legislation requires issuers to report on business

[30] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (quoted in and applied by Basic, Inc. v. Levinson, 485 U.S. 224, 231–32 (1988)).

[31] 2010 Climate Guidance, *supra* note 3 at 6293 (citing 17 C.F.R. § 229.101(c)(1)(xii)).

[32] *Id.* at 6293 (citing 17 C.F.R. § 229.103). On the materiality threshold, see 2010 Climate Guidance, *id.* at 6293 & n.45 (quoting the instructions for Item 103, which requires disclosure of "proceedings . . . arising under any Federal, State, or local provisions . . . regulating the discharge of materials into the environment or primary [sic] for the purpose of protecting the environment" if the proceeding is material, or if a governmental authority is party to the proceeding and it may result in liability exceeding $100,000).

[33] 17 C.F.R. § 229.503.

[34] 17 C.F.R. § 229.303(a)(3)(ii).

[35] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, §§ 1502–1504, 124 Stat. 1376, 2213–22 (2010) (codified at 15 U.S.C. § 78m (2012)); 17 C.F.R. § 229.104 (mine safety); *see also* Conflict Minerals, 77

activities in Iran.[36] Because these new ad hoc reporting requirements are not clearly grounded on the materiality standards that apply under the securities laws, they have weakened the business and legal communities' support for other ESG disclosure rules, even those that could be shown to be financially material.[37] Like the federal specialized disclosure rules, state measures are typically targeted at particular concerns and are intended not only to benefit investors but also to indirectly influence corporate behavior by shedding light on corporate impacts on particular stakeholders. The leading example at the state level is the California Transparency in Supply Chains Act of 2010, which requires companies with more than $100 million dollars in annual global gross revenue to disclose on their website their efforts to eliminate human trafficking throughout their supply chain.[38]

B. *Voluntary Reporting*

The primary source of ESG information disclosure comes from voluntary reporting rather than from companies' annual reports. Companies may determine their own format and ESG indicators, but most adopt independent reporting standards, such as the comprehensive standards developed by the Global Reporting Initiative (GRI), or the Climate Disclosure Project (CDP)'s environmental reporting standards.[39] Investors require information that is timely, reliable, consistent, and comparable among firms and over time, but voluntary reporting does not meet this standard and cannot be readily integrated with related information contained in financial reporting.[40]

Several key features of these voluntary reporting regimes limit their usefulness as the basis of investment analysis. First, current standards increasingly encourage quantitative metrics, but voluntary reporting has tended to be heavily qualitative and focused on positive rather than negative indicators. Second, in contrast to financial reporting, voluntary dis-

Fed. Reg. 56,274 (2012); Disclosure of Payments by Resource Extraction Issuers, 77 Fed. Reg. 56,365 (2012); Mine Safety Disclosure, 76 Fed. Reg. 81,762 (2011).

[36] Iran Threat Reduction and Syria Human Rights Act of 2012, Pub. L. No. 112-158, § 219, 126 Stat. 1214, 1235–36 (amending the Securities Exchange Act of 1934 § 13(a) to add subsection (r)).

[37] The D.C. Circuit has concluded that the conflict minerals disclosures were not mandated by Congress to further the SEC's regulatory mission but instead to address human rights concerns in the Congo. Nat'l Ass'n of Mfrs. v. SEC, 800 F.3d 518, 522, 524 (D.C. Cir. 2015).

[38] CAL. CIV. CODE § 1714.43 (2016).

[39] GLOB. REPORTING INITIATIVE, AN INTRODUCTION TO G4: THE NEXT GENERATION OF SUSTAINABILITY REPORTING, https://www.globalreporting.org/resourcelibrary/GRI-An-Introduction-to-G4.pdf; *About Us*, CDP, https://www.cdp.net/en/info/about-us.

[40] *See, e.g.*, TCFD, *supra* note 10, at 7–11.

closure regimes use transparency and the threat of reputational risk not only for its own sake, to promote better disclosure, but also to motivate companies to reduce their impacts on external stakeholders. Because they are designed for a range of corporate stakeholders, not only for investors, voluntary regimes adopt a broader definition of materiality than applies under the federal securities laws. Third, the reliability of voluntary reporting and its power to influence corporate practice depends largely on private auditing or "assurance" systems that attest to the integrity of the disclosure process. However, since companies also determine whether or not to seek third-party assurance or auditing, the level of assurance is uneven. Only about 12% of the S&P 500 elect to do so.[41] And unlike financial auditing, there are, as yet, no uniform standards for ESG assurance providers.[42] Finally, the timing and consistency of firm voluntary reporting varies widely, with many firms reporting on varying time periods and on a less-than-annual basis. Integrating voluntary reporting with analysis from the financial statements is difficult because voluntary disclosures are often released at different times than periodic reporting.[43]

C. *The Limits of ESG Reporting & Global Responses*

For all of these reasons, ESG reporting remains inadequate for financial analysis, even as the quantity of publicly available ESG information has grown exponentially. Many investors continue to express concern about the inadequacy of nonfinancial disclosure in their annual reports and in proxy disclosures, even for areas like material climate-related risks that have been the subject of SEC regulatory guidance.[44] However, even with the emergence of globally recognized and widely adopted reporting frameworks, such as those developed by GRI and CDP, and ESG ratings systems that attempt to reduce reporting quality to comparable indicators, voluntary reporting remains inconsistent and relatively costly to integrate into investment analysis. A 2016 report of the Task Force on Climate-Related Financial Disclosures, which was formed by the

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[41] THE CONFERENCE BD., SUSTAINABILITY PRACTICES 2015: KEY FINDINGS 6, https://www2.deloitte.com/content/dam/Deloitte/us/Documents/center-for-corporate-governance/us-aers-ccg-sustainability-practices-report-the-conference-board-050815.pdf.

[42] The American Institute of CPAs (AICPA) is currently developing assurance guidelines that would apply to sustainability audits conducted by accountants. *See Sustainability Assurance*, AM. INST. OF CPAS, http://www.aicpa.org/InterestAreas/BusinessIndustryAndGovernment/Resources/Sustainability/Pages/Sustainability%20Assurance%20and%20Other%20Services.aspx (last visited Apr. 4, 2017).

[43] CFA INST., ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES IN INVESTING: A GUIDE FOR INVESTMENT PROFESSIONALS 30 (Oct. 2015).

[44] *See, e.g.*, *id.* ("At present, mandatory corporate disclosure provides limited information on ESG-related risks and opportunities."); Concept Release, *supra* note 5, at 23,970 & n.664 (citing sources). "Some commentators . . . stated their belief that information made available to investors is inconsistent and incomplete." *Id.* at 23,970.

Financial Stability Board to develop voluntary disclosure principles and guidelines for climate-related financial reporting, notes that the current fragmented approach to ESG reporting may leave regulators without reliable information that could be used to evaluate and respond to such risks.[45]

In part, the deficiencies of public ESG information are a side effect of the flexibility the current mix of voluntary and mandatory ESG reporting provides. For purposes of financial reporting, the materiality of ESG information is a determination over which corporate management has discretion, so ESG issues may be under-reported, particularly if firms are not adequately identifying and monitoring ESG risk. Under voluntary reporting, companies can determine the scope, audience, and content of disclosure and often the reporting standard, if any, they will adopt. This flexibility has resulted in companies disclosing ESG information largely outside of financial reporting, at considerable cost, and in a way that is ultimately not useful to investors. At the same time, expanding ESG disclosure outside financial reporting does not reduce issuers' legal risk, since the SEC has stated that the antifraud provisions of the securities laws apply equally to information companies provide to investors via third parties, on their website, or in other sources outside their periodic reporting.[46]

In an effort to improve the quality and comparability of ESG disclosures, over 35 jurisdictions from the U.K. to Brazil have issued ESG reporting guidance or adopted mandatory ESG reporting rules either within their company law or through measures issued by financial regulators or stock exchanges.[47] Over time, an increasing number of jurisdictions, including most recently Hong Kong, have used voluntary guidelines as a transition to mandatory reporting requirements. Most ESG reporting mandates are limited to the largest issuers or to firms in certain sectors,[48] and regulators anticipate that market leaders will set the standard for reporting that other firms will follow. However, ESG disclosure remains grounded in voluntary reporting in all jurisdictions, since privately held

[45] TCFD, *supra* note 10, at 9.

[46] Commission Guidance on the Use of Company Websites, 73 Fed. Reg. 45,862, 45,869–70 (Aug. 7, 2008), (referencing the "2000 Electronics Release," Use of Electronic Media, SEC Release No. 33-7856 (Apr. 28, 2000)).

[47] These numbers were obtained from the sustainability reporting data compiled by SSEI as of 2014 for all jurisdictions globally and available for download at http://www.sseinitiative.org/data/sustainabilityreporting/.

[48] Bartels et al., *supra* note 2, at 16–17 (reporting that 30% of these mandates apply only to large listed firms); *see also* Council Directive 2014/95, of the European Parliament and of the Council of 22 October 2014, 2014 O.J. (L 330) 4 (applying only to "large undertakings" or consolidated corporate groups with more than 500 employees).

companies and many listed firms lie beyond the scope of these mandatory ESG reporting rules.

III. "COMPLY OR EXPLAIN": AN ASSESSMENT

Assuming for present purposes that certain ESG indicators are in fact material and that current reporting within and outside periodic reporting is inadequate, issues I consider more fully elsewhere,[49] then incorporating ESG disclosure more systematically into public reporting guidance or regulation may be the most effective way of improving its quality and reliability so that it can be integrated into investment analysis. However, the lack of consensus about the relative costs and benefits of mandatory ESG disclosure and uncertainty about the best way to tailor specific reporting requirements present practical obstacles to developing a more coherent and predictable approach to ESG reporting. A comply-or-explain approach to ESG disclosure and practice may offer a useful alternative as a tool for improving corporate governance practice and investor access to ESG information given its widespread adoption in other jurisdictions, and even to a limited extent in the U.S. This Part offers further detail on how comply-or-explain frameworks operate and presents the findings from the empirical literature to date on how effective they have been in practice.

A. *Explaining Comply or Explain*

As explained earlier, the comply-or-explain model allows regulators to create a code of best practices and to define the universe of firms to which it will apply. Companies can comply with the code directly, by implementing some or all of the code's provisions, or by explaining why they have elected not to do so.[50] In some cases, comply-or-explain rules can be satisfied by providing a statement of compliance or an explanation of deviation on the company's website, but most regulators require the disclosures to be made in the company's annual reporting.[51] In general, comply-or-explain codes operate in tandem with legislative mandates rather than displacing them, with mandatory rules representing a

[49] *See generally* Harper Ho, *supra* note 17 (assessing the evidence for ESG materiality and the rationales for investor activism directed at improving ESG disclosure and performance).

[50] Companies are not permitted to deviate from the foundational principles of the underlying code, only from specific code provisions. *See, e.g.*, FIN. REPORTING COUNCIL (FRC), WHAT CONSTITUTES AN EXPLANATION UNDER 'COMPLY OR EXPLAIN'? REPORT OF DISCUSSIONS BETWEEN COMPANIES AND INVESTORS 5 (Feb. 2012).

[51] Under the 2014 E.U.'s Nonfinancial Transparency Directive, the nonfinancial statement must be included in the required management report unless the reporting "undertaking" already disclosed the information in a separate report. *See* Council Directive 2014/95, *supra* note 48, at 4–5.

lower floor that applies to all companies and comply-or-explain-based codes setting a higher standard of best practices.[52] Their precise content also varies across jurisdictions.[53]

Comply or explain therefore represents an intermediate approach to regulation, and there is some divergence of views on whether comply or explain is in fact a mandatory or voluntary approach.[54] On the one hand, it is mandatory insofar as all companies must either comply or explain based on the same code provisions. At the same time, because conformity to the code is not required, the codes themselves represent a form of soft law or self-regulation. In some contrast to the U.S. model of dual regulatory and private enforcement, comply-or-explain regimes are typically enforced by shareholder monitoring and by the market itself rather than by regulators.[55] In any event, the fact that comply or explain is neither fully mandatory nor fully voluntary makes it an attractive alternative in contexts where both flexibility and consistency are important, whether across jurisdictions or across firms.

One aspect of comply-or-explain-based codes that is important to consider in evaluating whether they are a potential model for ESG disclosure in the U.S. is that comply-or-explain reporting has been most widely adopted as an alternative regulatory approach to corporate governance. Some of the more recent examples of comply-or-explain tools, including the European Commission's 2014 Nonfinancial Transparency Directive, extend these frameworks beyond corporate governance to include environmental, health and safety, and human rights policies, outcomes, and risks, including risk of adverse impact on external stakeholders of the firm.[56] Many of the earliest corporate governance codes to incorporate comply-or-explain principles also include sustainability or other CSR-related disclosure within the code's best practices, making them better

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[52] *See Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States*, RiskMetrics Group, at 31–46 (Sept. 23, 2009), http://ec.europa.eu/internal_market/company/docs/ecgforum/studies/comply-or-explain-090923_en.pdf [hereinafter *EC Corp. Governance Study*] (discussing the interplay between legislation and the codes).

[53] *See, e.g.*, Niels Hermes et al., *Corporate Governance Codes in the European Union: Are They Driven by External or Domestic Forces?*, 2 Int'l J. Managerial Fin. 280, 287–90 (2006) (observing divergence among European codes).

[54] *See, e.g.*, Andrew Keay, *Comply or Explain in Corporate Governance Codes: In Need of Greater Regulatory Oversight?*, 34 Legal Stud. 279, 279 (2014) (referring to corporate governance codes as voluntary regimes and "soft law"); David Seidl et al., *Applying the 'Comply-or-Explain' Principle: Discursive Legitimacy Tactics with Regard to Codes of Corporate Governance*, 17 J. Mgmt. & Governance 791, 815 (2013) (referring to comply or explain "as a particular type of enforced self-regulatory regime").

[55] *See EC Corp. Governance Study*, *supra* note 52, at 70–73; Keay, *supra* note 54, at 280. *But see EC Corp. Governance Study*, *supra* note 52, at 63 (describing administrative enforcement tools adopted in Portugal and Spain).

[56] *See* Council Directive 2014/95, *supra* note 48, at 2, 4–5.

precedent for ESG-disclosure reform. The Singapore and Hong Kong stock exchanges have also recently introduced ESG reporting mandates on a comply-or-explain basis that are intended to improve ESG disclosure quality and market efficiency.[57] However, these frameworks are too new to have generated empirical evidence that can be considered here.

The regulatory objectives of comply or explain in most jurisdictions—motivating compliance with the corporate governance code—therefore differ from the core goals of securities disclosure as interpreted by the SEC, a point I return to in Part IV. In brief, the SEC sees its primary mission as promoting market transparency and efficiency and protecting investors. Although ESG information may be material precisely because of its correlation with corporate governance, the SEC may be hesitant to adopt guidance or enact disclosure rules that use transparency to incentivize corporate reform. However, it is noteworthy that some of the few instances where U.S. disclosure rules adopt a comply-or-explain approach, as discussed below, came into being as part of broader legislative responses that targeted particular corporate conduct.[58]

B. *Assessing the Impact: A Comparative Perspective*

The conceptual literature on comply or explain emphasizes that it offers greater flexibility for issuers while enhancing the reliability and comparability of ESG reporting for investors. Comply-or-explain systems also give companies and regulators the opportunity to identify weaknesses, inefficiencies, or actual legal conflicts created by the code in the course of providing "principled justifications" for deviation.[59]

However, evidence from a number of jurisdictions has identified several potential weaknesses as well.[60] The greatest concerns are that companies may give perfunctory explanations for deviations from the code and that relatively few firms will comply by adopting the code's best practices. Comply or explain may then become simply a "check the box" exercise that again produces more, but not better, information for investors. A related concern is that a comply-or-explain model may be less well-suited to adoption in continental Europe or in emerging markets that lack the shareholder-oriented corporate governance foundations of

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[57] HONG KONG STOCK EXCH., MAIN BOARD LISTING RULES ch. 13.91, apps. 14, 27, http://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/Documents/consol_mb.pdf; SINGAPORE EXCHANGE, MAINBOARD RULES § 1207(12), http://rulebook.sgx.com/en/display/display_viewall.html?rbid=3271&element_id=4830.

[58] *See infra* Part III.B.1.

[59] Seidl et al., *supra* note 54, at 793–94, 809.

[60] *See, e.g.*, Reints Abma & Mieke Olaerts, *Is the Comply or Explain Principle a Suitable Mechanism for Corporate Governance Throughout the EU?: The Dutch Experience*, 9 EUR. COMPANY L. 286, 288–89 (2012) (summarizing potential drawbacks of the comply-or-explain rule).

U.K. law, where comply or explain originated. Few codes contain penalties for inadequate or missing explanations, and even in shareholder-centric jurisdictions, comply-or-explain regimes rely on enforcement by institutional investors who may prefer to remain passive rather than engage companies around governance issues.[61] Companies may also find it costly to provide meaningful explanations for their deviations from the code, and those costs will rise with the number of explanations that are needed if the code itself is a poor fit for most companies. Some commentators have also expressed the opposite concern, that the market will (mistakenly) punish firms for any deviations from the code, even where deviations are in fact optimal for the firm.[62]

Since comply-or-explain models have already been widely adopted, a useful starting point to evaluate its potential is to assess the evidence of its success or failure in the U.S. and in jurisdictions where it has been more widely implemented. A small but growing literature has developed over the past fifteen years that analyzes the impact of comply-or-explain regulation. While most studies focus on the effectiveness of corporate governance codes that are based on the comply-or-explain model, a few also address the implementation of code provisions that focus on sustainability or CSR-related disclosure. The majority of these studies measure compliance only in terms of the adoption of code best practices, while fewer analyze the sufficiency of explanations of deviation.[63] Since either conformity to the code or explanations of deviation constitute compliance under the code, both are relevant in measuring the success of this disclosure model. Appendix A summarizes the empirical studies and their primary findings on the effectiveness of comply or explain.

Overall, the evidence suggests that comply-or-explain regimes are highly effective in motivating firm compliance, at least in developed capital markets.[64] This conclusion holds both for shareholder-oriented regimes that follow the U.K. model, such as Canada and Australia, as well as for jurisdictions with more heavily stakeholder-oriented corporate governance structures, such as Germany. It also appears to be the case from the limited evidence available in the U.S. to date. There is also some evidence from within the European Union that comply-or-explain-based codes may facilitate later legislation by allowing companies to adapt to a

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[61] *See The EU Corporate Governance Framework*, at 19, COM (2011) 164 final (Apr. 5, 2011), http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf (describing Member State reliance on passive investors); Keay, *supra* note 54, at 285–88 (arguing that private enforcement is inadequate).

[62] *See, e.g.*, Abma & Olaerts, *supra* note 60, at 289.

[63] *See* Seidl et al., *supra* note 54, at 792–93 (surveying the literature).

[64] *See EC Corp. Governance Study*, *supra* note 52, at 126 (finding that over 90% of deviations were related to only a few governance principles, largely executive compensation and certain aspects of board composition).

"new normal" over time, which is then incorporated in law.[65] There is also some evidence that compliance by adoption may increase over time.[66]

Empirical studies observe differences across jurisdictions with regard to whether compliance is more common through adoption of the code's best practices or through deviation with adequate explanation.[67] However, a persistent challenge identified in the empirical literature to date concerns the adequacy of explanations, supporting the conclusion that many firms are in fact "checking the box" without providing an appropriate response to investors.[68] Appendix B includes examples of adequate and deficient explanations that illustrate this concern. The problem of inadequate explanations was central in a 2009 review of comply-or-explain reporting conducted by the European Commission, which found "overwhelming support for the comply-or-explain regime from regulators, companies [and] investors," but nonetheless determined that only 39% of the explanations provided were adequate.[69] The EU review and other commentators have suggested strengthening external auditing

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[65] *Id.* at 11 (reporting that legislation tends to mandate shareholder rights and board structure, whereas practices such as risk management, board independence, and the creation of nominating and compensation committees are more likely to be contained in codes).

[66] A study by Sridhar Arcot et al. observed that explanations do not improve over time, but that companies tend to move toward adoption of the code provisions over time to a degree that may not be efficient for those firms. Sridhar Arcot, et al., *Corporate Governance in the UK: Is the Comply or Explain Approach Working?*, 30 INT'L REV. L. & ECON. 193, 199 (2010).

[67] The observed variation in implementation and practice within the European Union has caused some scholars to criticize comply or explain for its failure to bring about greater harmonization within Europe, but these critiques are less relevant to the question of its usefulness as a disclosure tool. *See* Hermes et al., *supra* note 53 (observing divergence among European codes); *see also* Shuangge Wen, *Less Is More—A Critical View of Further EU Action Towards a Harmonized Corporate Governance Framework in the Wake of the Crisis*, 12 WASH. U. GLOBAL STUD. L. REV. 41 (2013) (arguing that the EU should abandon the goal of harmonization).

[68] *See* Reggy Hooghiemstra & Hans van Ees, *Uniformity as Response to Soft Law: Evidence from Compliance and Non-Compliance with the Dutch Corporate Governance Code*, 5 REG. & GOVERNANCE 480, 481 (2011) (finding evidence of a "one-size-fits-all approach to non-compliance").

[69] *EC Corp. Governance Study*, *supra* note 52, at 12. The study surveyed 270 firms from 18 Member States, as well as corporate directors and EU shareholders, and classified responses as "adequate" that either indicated a temporary deviation or provided a specific explanation. *See id.* at 13–14; *see also The EU Corporate Governance Framework*, *supra* note 61, at 18–20 (considering measures to improve the quality of explanations). The U.K.'s guidance on the adequacy of explanations indicates that meaningful explanations should "set the context and . . . background, . . . give a convincing rationale . . . and describe mitigating action to . . . maintain conformity with the relevant principle." FRC, *supra* note 50, at 6.

mechanisms in order to motivate better compliance by explanation.[70] The similarity among explanations for similar deviations also suggests that firms may be under pressure to adopt the code standard and that firms and regulators are failing to fully benefit from the flexibility comply or explain affords.

Despite the need for continued progress, the consistent findings from the studies to date are that overall compliance is quite high under comply-or-explain regimes, and that the informational content of explanations in most cases is also quite high. Another important finding supported by a number of studies is that the rate of compliance by explanation and the rate of inadequate explanations both appear to rise for code principles that are related to sustainability or to risk management, an area potentially encompassing ESG risk. This suggests a gap between the standards set by the codes and mainstream practice, and that mandatory reporting requirements for some ESG information might therefore be premature. However, one limitation of the literature reviewed here is the small number of empirical studies; studies comparing firms over time and across jurisdictions are particularly rare. Further research is needed to facilitate stronger conclusions about the reasons for variation among jurisdictions and why comply or explain is more successful in some jurisdictions than in others.

1. The United States

Although most U.S. disclosure rules are mandatory, comply-or-explain provisions have, in fact, already been introduced to a limited extent over the past decade. One such example is section 406 of the Sarbanes-Oxley Act of 2002, which requires firms to disclose whether they have adopted a code of ethics for senior financial officers or to explain why they have not.[71] A more recent example appears in the SEC's new pay ratio rules under section 953(b) of the Dodd-Frank Act, which requires public companies to disclose the ratio of the CEO's compensation to the median compensation of employees.[72] The rules define how total compensation for employees should be calculated, but permit companies to use a different measure as long as they explain their approach. Evidence of the implementation of section 406 from one sample of 200 public companies suggests that U.S. practice mirrors, to some extent, patterns observed in Australia and the U.K., discussed below. The study finds

[70] *EC Corp. Governance Study*, *supra* note 52, at 17, 178–79. Investor stewardship reforms designed to encourage more active investor monitoring have also been introduced. *See id.* at 185–88; *see also* Abma & Olaerts, *supra* note 60, at 297 (supporting stronger enforcement); Keay, *supra* note 54, at 303–04 (same).

[71] Sarbanes-Oxley Act of 2002 § 406(a)–(b), 15 U.S.C. § 7264 (2012).

[72] Dodd-Frank Act of 2010 § 953(b), 124 Stat. at 1904; *see also* SEC Pay Ratio Disclosure, 80 Fed. Reg. 50,104 (Aug. 18, 2015) (promulgating rules putting § 953(b) into effect).

that since section 406 was enacted, nearly all firms have adopted an ethics code, so the rule had essentially the same effect as a direct mandate.[73] However, this same study also observed that market prices did not appear to respond to disclosed deviations from the ethics code.[74] This finding mirrors indications from jurisdictions with comply-or-explain corporate governance codes suggesting that markets fail to distinguish adequate and deficient explanations of deviation and instead may misinterpret explanations as non-compliance.[75]

2. Anglo-European Markets

The EU adopted a comply-or-explain approach to corporate governance in 2006 in recognition of variation in corporate practice, ownership structures, and corporate governance regimes among its member states.[76] The code requires listed companies in Member States to produce a corporate governance statement and provide certain information on its corporate governance structures and procedures.[77] Since then, a number of studies have examined its success in specific jurisdictions, each of which have differing company law regimes and market conditions and each of which vary with respect to the precise scope of the codes and the extent to which they address risk management and ESG issues specifically.[78] These studies focus on compliance with corporate governance codes, since even the most recent predate the implementation of the EC's 2014 Nonfinancial Transparency Directive, which focuses more directly on ESG disclosure.

Germany: A comparative study published in 2013 found similar results for the largest listed firms in Germany, with over 85% of firms complying through explanation. In both cases, explanations were used most often for code provisions that were most controversial, such as majority inde-

[73] *See* Usha Rodrigues & Mike Stegemoller, *Placebo Ethics: A Study in Securities Disclosure Arbitrage*, 96 VA. L. REV. 1, 7 (2010). Whether compliance translates into improved corporate practice is, of course, a separate question. This study looked not only at ethics code adoption under § 406 but also at the rule's usefulness in preventing the types of related-party transactions that motivated its adoption in the first place. The authors concluded that disclosure functions less effectively as a regulatory tool, since nearly one-third of the companies in their sample either diluted their codes to permit questionable related-party transactions or failed to report transactions that should have required a public waiver of the ethics code. *See id.* at 8.

[74] *Id.* at 60–63.

[75] *See, e.g.*, Arcot et al., *supra* note 66, at 193–94 (concluding that "the market as a whole seems to be ignoring the explanations provided").

[76] Council Directive 2006/46, 2006 O.J. (L 224) 1 (EC); *see also EC Corp. Governance Study*, *supra* note 52, at 11–12 (describing the origins of comply or explain and its evolution since 2006).

[77] *See EC Corp. Governance Study*, *supra* note 52, at 27 (summarizing the content of Council Directive 2006/46).

[78] Further detail on the variation among Member State market conditions and compliance levels is in the EC Corporate Governance Study. *Id.* at 25–30, 88–97.

pendence for board and nomination committee and composition of the audit committee. An early study had observed a high degree of code compliance and indications that the introduction of the code was driving changes in firm practice.[79] However, the 2013 study also found that over half of the explanations provided were deficient.[80]

Netherlands: Both the 2004 Dutch corporate governance code and its company law incorporate comply-or-explain principles, and the relevant compliance report or explanation must appear in the company's annual accounts.[81] A distinctive feature of the Dutch model is that not only are there indications that shareholders of Dutch companies are taking an increasingly active monitoring role, but the Netherlands has created a Corporate Governance Code Monitoring Committee.[82] Studies on the implementation of comply or explain among Dutch listed firms find high levels of conformity with the corporate governance code, as in Denmark, indicating that comply or explain is an adequate regulatory tool for moving companies toward best practices.[83] However, they also show that most deviating firms either provide generic boilerplate explanations or provide no explanation at all.[84] This type of "over-conformity" may indicate that firms are not following the spirit of the code or comply-or-explain principles.[85]

Denmark: The purpose of the 2001 Danish Code, broadly, is to "ensure that shareholders and other stakeholders are able to evaluate the performance of publicly traded companies."[86] The Danish corporate governance code is an important example not only because Denmark was one of the earliest to adopt a comply-or-explain approach, but also because the Danish Code explicitly includes corporate governance best practices that are linked to corporate social responsibility and stakehold-

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[79] Axel v. Werder et al., *Compliance with the German Corporate Governance Code: An Empirical Analysis of the Compliance Statements by German Listed Companies*, 13 CORP. GOVERNANCE 178, 185 (2005).

[80] *See* Seidl et al., *supra* note 54, at 807 (noting, however, that during 2005–2006, the periods covered by the study, explanations were recommended but not required under German law).

[81] Abma & Olaerts, *supra* note 60, at 291.

[82] *Id.* at 291–92 (noting a rise in shareholder voting and engagement as well as governance-related litigation).

[83] *See* Dirk Akkermans et al., *Corporate Governance in the Netherlands: An Overview of the Application of the Tabaksblat Code in 2004*, 15 CORP. GOVERNANCE 1106 (2007) (analyzing annual reports of 150 Dutch listed companies in 2004).

[84] Abma & Olaerts, *supra* note 60, at 293–94 (analyzing annual reports for 100 Dutch listed firms for 2009); Akkermans et al., *supra* note 83, at 1115; Hooghiemstra & van Ees, *supra* note 68, at 493–94 (using a sample of 126 listed Dutch firms).

[85] *See* Hooghiemstra & van Ees, *supra* note 68, at 481.

[86] Caspar Rose, *Listed Firms' Level of Stakeholder Transparency—The Comply or Explain Evidence from the Danish Corporate Governance Code*, 10 INT'L J. BUS. SCI. & APPLIED MGMT., no. 2, 2015, at 1, 2 (citing the 2010 Danish Code).

er impacts, albeit at a fairly general level. For example, the Danish Code requires companies to adopt a stakeholder policy and a CSR policy.[87] One study using data from the 2010 fiscal year for 80% of the companies listed on the Nasdaq OMX Copenhagen found that nearly 60% of companies adopt code practices rather than explain deviations and that, on average, over 90% of companies were compliant overall across the surveyed indicators.[88] However, an important caveat from this study is that by 2010, adoption of a CSR policy was legally required under Danish law, but 21% of the firms were deviating from that standard and around 15% of firms provided non-responsive explanations for the deviation.[89] This finding suggests that the gap between the code's CSR expectations and corporate practice was quite high. The study also found a high percentage of deficient explanations for certain indicators.[90]

United Kingdom: The U.K. was the first to introduce comply-or-explain reporting a decade ago. In the U.K., comply-or-explain principles are embedded in the 2006 Company Law and in the London Stock Exchange listing rules.[91] Studies on the impact of the U.K.'s corporate governance code from the mid-2000s identify a high prevalence of boilerplate explanations and a high percentage of missing explanations (in some cases upwards of 20%).[92] A similar review by the U.K. Financial Reporting Council (FRC) in 2009 also found indications of widely used boilerplate,[93] prompting the FRC to issue new guidance in 2012 aptly titled "*What Constitutes an Explanation under Comply or Explain?*"[94]

A more recent study by the FRC found higher levels of compliance. In 2012, it found that FTSE 350 firms adopted, on average, 96% of the U.K. Corporate Governance Code, and half of the companies adopted it

[87] *See id.* at 7 (describing these requirements).

[88] *See id.* at 4–5 (indicating that 87 of the 155 firms in the sample comply with the code recommendations by adoption rather than explanation); *see also* Caspar Rose, *Firm Performance and Comply or Explain Disclosure in Corporate Governance,* 34 EUR. MGMT. J. 202, 210 (2016) (reporting results based on the same study).

[89] Rose, *supra* note 86, at 7.

[90] *See id.* at 5–7 (finding that although the percentage of firms providing explanations in this study was quite low for most indicators, the average percentage of those explanations that was deficient was nearly 40%).

[91] *See* FIN. REPORTING COUNCIL (FRC), THE U.K. APPROACH TO CORPORATE GOVERNANCE 4 (Oct. 2010).

[92] *See* Arcot et al., *supra* note 66, at 196–97 (analyzing 245 annual reports of UK non-financial companies from 1998–2004); Ian MacNeil & Xiao Li, *"Comply or Explain": Market Discipline and Non-Compliance with the Combined Code*, 14 CORP. GOVERNANCE 486, 488–90 (2006) (finding many explanations are not informative to investors); Seidl et al., *supra* note 54, at 807 (finding over 40% of explanations deficient in a study from annual reports published in 2006).

[93] FIN. REPORTING COUNCIL (FRC), 2009 REVIEW OF THE COMBINED CODE: FINAL REPORT 31 (Dec. 2009).

[94] FRC, *supra* note 50.

in its entirety. That same study also found that about two-thirds of the firms that chose to deviate provided meaningful explanations.[95] At the same time, one of the other primary studies on the implementation of comply or explain in the U.K. from 2013 concluded that "concerns about companies being driven towards full compliance [with code best practices that may be inefficient] are largely unfounded."[96] However, the study also reported an increase in the absolute number of deviations for smaller firms, and in the percentage of deficient explanations.[97] This result suggests that smaller firms, not surprisingly, have less capacity to attain best practices.

Canada & Australia: A 2013 study by Salterio et al., comparing implementation by public companies in Canada and Australia found compliance levels of over 70% across 16 corporate governance dimensions in both markets, but differences in the form of compliance across the two jurisdictions.[98] In particular, the study found that compliance by explanation was more common in Australia than in Canada (20% of the principles relative to 4%), whereas compliance by conformity to best practice was more common in Canada (82% compared to 70% in Australia). The study also found distinctions in the particular best practices that were more widely adopted by listed companies in each jurisdiction. In both jurisdictions, the study observed high rates of noncompliance, up to 25% for some principles (and in Canada, one just over 50%), suggesting a need for stricter enforcement.[99]

A related study analyzing single-year data from all Canadian listed firms across 47 corporate governance dimensions found that firms are not using the flexibility of the comply-or-explain model to weaken corporate governance, but on the contrary, explanations largely reflected efficient deviations where the firm adopted corporate governance practices better suited to unique firm circumstances than the "best practice"

[95] *Id.* at 1 (noting that no firm failed to provide any explanation at all).

[96] Seidl et al., *supra* note 54, at 800. Evidence for this conclusion comes from the fact that nearly half of the largest U.K. public companies in the sample adopted some form of explanation rather than reporting direct conformity to the code. *Id.* at 799 tbl.2. These figures are quite similar to the results of the FRC's own study in 2012. *See* FRC, *supra* note 50, at 1.

[97] Seidl et al., *supra* note 54, at 800, 807.

[98] Steven E. Salterio et al., *Canadian Evidence of Adherence to "Comply or Explain" Corporate Governance Codes: An International Comparison*, 12 ACCT. PERSP. 23, 39–43 (2013) (analyzing compliance with 16 corporate governance code principles for 742 listed Canadian firms in annual reports and proxy statements for FY2006 and similar principles from annual reports of 1,334 Australian listed firms for 2006–07).

[99] *Id.* at 35–38, 40 (finding highest noncompliance rates in Canada for principles related to independent directors and adoption of ethics codes).

standard.[100] These results suggest that comply-or-explain reporting has allowed firms to transition more gradually to novel governance practices.

3. Emerging Markets

Evidence on comply-or-explain corporate governance regimes is less uniform across emerging markets, and most of the studies today focus on code implementation in Eastern Europe. These studies tend to find lower levels of compliance compared to other European countries, both in the aggregate and in terms of the adequacy of explanations. One study done in 2010 in Slovenia found that reporting quality was poor overall and concluded that comply-or-explain disclosure is not as effective in transitioning economies.[101] In contrast to more developed European markets, a study using data from 144 Greek listed firms in 2011 found low compliance both in terms of conduct, with only 35% adopting code-based practices, and by explanation, with over half of the remaining 65% failing to provide any explanation at all.[102]

Despite the weaker success of comply-or-explain models in emerging markets, a recent study comparing corporate governance reforms in 41 countries suggests that comply-or-explain approaches to corporate governance may be a more effective tool for shaping corporate practice in such markets than prescriptive codes.[103] This study found a stronger positive effect of corporate governance reform on financial performance in jurisdictions with a more flexible, comply-or-explain approach, perhaps because comply-or-explain regimes require less institutional support.[104]

[100] Yan Luo & Steven E. Salterio, *Governance Quality in a "Comply or Explain" Governance Disclosure Regime*, 22 CORP. GOVERNANCE 461, 476 (2014) (analyzing compliance with 47 corporate governance code principles for all 655 listed Canadian firms based on annual reports and proxy statements for 2006).

[101] Nina K. Cankar et al., *The Reflexive Properties of Corporate Governance Codes: The Reception of the 'Comply-or-Explain' Approach in Slovenia*, 37 J.L. & SOC'Y 501, 521, 524–25 (2010) (analyzing compliance with the 2004 Slovenian Corporate Governance Code and reporting surprisingly high uniformity both in the types of deviations and in the content of related explanations).

[102] Michail Nerantzidis, *Measuring the Quality of the "Comply or Explain" Approach: Evidence from the Implementation of the Greek Corporate Governance Code*, 30 MANAGERIAL AUDITING J. 373, 387–88 (2015) (analyzing compliance with over 52 corporate governance variables). A similar study on Croatian listed firms in 2011 found that 63% of the companies adopted the code, with 95% of those self-reporting full compliance; however, the study did not analyze adoption or explanation with specific code provisions. *See* Hana Horak & Nada Bodiroga-Vukobrat, *EU Member States' Experiences with the 'Comply or Explain' Principle in Corporate Governance*, 7 CROAT. Y.B. EUR. L. & POL'Y 179, 196–99 (2011) (analyzing data from 265 listed firms' annual reports in 2010).

[103] *See* Larry Fauver et. al., *Board Reforms and Firm Value: Worldwide Evidence* 7, 24 (HKUST Inst. for Emerging Mkt. Studies, Working Paper No. 2015-20, 2015) (analyzing data on corporate governance reform from 1990–2012).

[104] *See id.* at 26–27.

IV. "COMPLY OR EXPLAIN": A NEW MODEL OF ESG DISCLOSURE IN THE U.S.

The positive evidence of compliance from jurisdictions that have adopted a comply-or-explain approach suggests that it may offer an efficient alternative to prescriptive line-item disclosures in the event that the SEC determines that new approaches to nonfinancial disclosure are needed. The proposal here is not that the SEC should abandon its commitment to a rule-based disclosure system in favor of comply-or-explain disclosure, but instead that the SEC could selectively introduce new ESG disclosure requirements on a comply-or-explain basis. This approach responds to many of the concerns the SEC and other commentators have previously expressed about expanding disclosure mandates and about mandatory ESG reporting specifically. The choice of a comply-or-explain model along the lines suggested here would also provide a mechanism for the continued evolution and development of ESG reporting frameworks over time, which is also a priority of the SEC as it considers future disclosure reform.[105]

A. *Potential Comply-or-Explain Models*

In general, any disclosure reforms that could be adopted as a line-item disclosure mandate under federal disclosure requirements could also be adopted on a comply-or-explain basis. However, any such expansion of ESG disclosure within periodic reporting must necessarily be grounded on a recognition of the financial materiality of ESG information for investors given the SEC's current understanding of its statutory authority. The SEC has stated that, absent a congressional mandate, "it generally is not authorized to consider the promotion of goals unrelated to the objectives of the federal securities laws when promulgating disclosure requirements."[106] Those objectives are "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[107]

Although both the Securities Act and the Exchange Act require the SEC to consider whether rulemaking is "necessary or appropriate in the public interest,"[108] the SEC has interpreted its authority to act in the public interest as delimited by its core mission to promote investor protec-

[105] *See* Concept Release, *supra* note 5, at 23,972 (seeking comment on how to ensure flexibility in identifying material sustainability information over time).

[106] *Id.* at 23,971.

[107] *Id.* at 23,972.

[108] *Id.* at 23,922 & n.54 (citing § 28 of the Securities Act, 15 U.S.C. § 77z–3 (2012) and § 36(a)(1) of the Exchange Act, 15 U.S.C. § 78mm (2012) (authorizing the SEC to grant exemptions to its rules or regulations)).

tion, market efficiency and competition, and capital formation.[109] Accordingly, any new ESG disclosure must be directed toward these goals rather than toward reducing stakeholder impacts and other corporate externalities. To fit within the existing regulatory framework and facilitate efficient investment analysis, ESG disclosure rules should also seek to elicit only material information, as defined by the U.S. Supreme Court, rather than adopting the broader stakeholder-oriented materiality standard used in voluntary reporting frameworks.[110]

Within these parameters, expanded ESG reporting on a comply-or-explain basis could take several different forms, some of which have already been introduced in other jurisdictions. In general, ESG reporting could expand existing corporate governance disclosures to include ESG oversight and risk management. For example, the Australian Stock Exchange (ASX) listing rules require companies to establish sound risk oversight and management systems, which are defined to include environmental and sustainability risks.[111] The SEC could also identify specific ESG risks that are material to most public companies and direct that they be disclosed on a comply-or-explain basis. One source for such indicators could be the ESG measures required to be disclosed by leading stock exchanges, such as the London or Hong Kong exchanges,[112] common indicators referenced in the GRI standards and other reporting frameworks, or indicators developed by the Sustainability Accounting Standards Board (SASB), a nonprofit organization that has distilled material ESG indicators for firms in 79 industry sectors in order to enhance the quality of ESG reporting under the securities laws.[113] The SEC could also follow the model of the EC's Nonfinancial Transparency Directive and require the firm to disclose on a comply-or-explain basis its policies addressing

[109] *Id.* at 23,917, 23,922 & nn.6 & 55 (citing Securities Exchange Act of 1933 § 2(b), 15 U.S.C. § 77b(b); Securities Exchange Act of 1934 § 3(f), 15 U.S.C. § 78c(f); and Securities Exchange Act of 1934 § 23(a)(2), 15 U.S.C. § 78w(a)(2)).

[110] *See* SEC, REPORT ON REVIEW OF DISCLOSURE REQUIREMENTS IN REGULATION S-K 94–95 (listing the economic principles that will drive the SEC's consideration of changes to disclosure requirements). The SEC is sensitive to the risk that new line-item requirements would result in disclosure of information that is not material to investors and could in fact drown out information that is necessary for investors to understand. *See* Concept Release, *supra* note 5, at 23,972.

[111] *See* HAUSER INST. FOR CIVIL SOC'Y, *supra* note 2, at 2 (discussing the ASX's 2014 corporate governance guidelines and Principle 7 of its prior listing rules).

[112] *See id.* at 14 (referencing the London Stock Exchange's emissions disclosure rules for listed companies); HONG KONG STOCK EXCH., *supra* note 57, at ch. 13, app. 27 (requiring greenhouse gas emissions disclosure within the annual reports on a comply-or-explain basis).

[113] *Navigator*, SUSTAINABILITY ACCOUNTING STANDARDS BD., https://navigator.sasb.org/. Empirical studies suggest that SASB's indicators may be stronger predictors of financial performance than accepted ESG indicators that are not based on the *TSC Industries* materiality standard. *See* Khan et al., *supra* note 21, at 1700–01, 1716–17.

ESG concerns,[114] or it could require the company to produce some form of ESG or sustainability disclosure, or explain why it does not. The GRI has recently begun a campaign to urge governments globally to adopt this kind of "report or explain" rule, which has already been implemented by some regulators, including Brazil's stock exchange.[115] The SEC could also establish best practice principles for voluntary ESG disclosure, such as the use of independent standards and third-party assurance, that would apply on a comply-or-explain basis. Although this approach may push the bounds of the SEC's investor protection mandate, requiring that all ESG reporting, whether within or beyond the financial reports, meet certain criteria could further improve the quality and comparability of voluntary reporting used by investors.

Regardless of the preferred approach, reporting companies would be free to comply by adopting the stated best practices or by providing meaningful explanations of why they deviate. A stronger model, which has been adopted in Sweden, would be to also require companies who opt to explain to include a description of the solution they have adopted instead.[116] All of the proposals presented here also presume that the SEC, rather than the stock exchanges, would take the initiative in any adoption of new ESG reporting guidelines or rule-making in the U.S., even though in other jurisdictions, stock exchanges, professional associations and other organizations have often taken the lead in introducing comply-or-explain regimes.

B. *Why Comply or Explain*

Requiring firms to disclose on a comply-or-explain basis material ESG information that the SEC determines is economically justified would produce a number of potential benefits for issuers, capital markets, and the SEC itself. Expanding investor access to information on ESG risks

[114] The EC Directive requires companies with over 500 employees, whether listed or not, to include in their management report a nonfinancial statement describing the due diligence and other policies the company has adopted with respect to environmental, social, human rights, anti-corruption and anti-bribery matters or to "provide a clear and reasoned explanation for not doing so." Council Directive 2014/95, *supra* note 48, at 330/4–5 (adding Article 19a to Council Directive 2013/34/EU).

[115] *See Report or Explain Campaign Forum*, Glob. Reporting Initiative, https://www.globalreporting.org/network/report-or-explain/Pages/default.aspx (describing GRI's efforts to advance the report-or-explain framework). The BOVESPA report-or-explain guidance was introduced in 2012. Press Release, BM&FBOVESPA Recommends Listed Companies Publish a Sustainability Report or Explain Why They Do Not, BM&FBOVESPA (Jan. 4, 2012), https://brazilianchamber.org.uk/sites/brazilianchamber.org.uk/files/comittee-files/document1.pdf.

[116] *See The EU Corporate Governance Framework*, *supra* note 61, at 19 (citing the Swedish code).

and corporate performance should enable markets to more efficiently price ESG risk and opportunity and capital to be more efficiently allocated to firms that better manage these risks.[117] Investors may in time reward firms that outperform both financially and in terms of reduced stakeholder impacts. In addition to capital allocation, comply-or-explain reporting offers advantages in terms of flexibility, its fit with the U.S. institutional framework, and potential efficiency gains from both a compliance and rule-making standpoint.

1. Flexibility

The primary advantages of a comply-or-explain approach are that allowing firms to explain deviations offers greater flexibility for issuers while enhancing the reliability and comparability of ESG reporting for investors. Although companies can comply with the spirit of the code in a manner that parts course from its particular standard of best practices, the evidence presented earlier suggests that comply-or-explain systems are effective in moving companies toward adoption of best practices. Another source of flexibility is the underlying code itself. Rather than attempt to craft one-size-fits-all rules for companies in different sectors, regulators can establish core principles to guide corporate practice and then allow greater variation for specific practices. The SEC's 2016 Concept Release indicates that it is interested in incorporating principles-based disclosure more extensively, even though U.S. reporting requirements are generally rule-based and principles-based approaches have historically been a hallmark of European reporting systems.[118] Giving firms flexibility to comply or explain may reduce resistance to the new measures even if most firms ultimately end up complying by directly adopting best practices.

The flexibility of a comply-or-explain approach to disclosure makes it particularly well-suited to disclosure of environmental and social issues where their materiality may vary widely among industries and firms and where firms' understanding of these risks is likely to deepen over time.[119]

[117] This possibility has been noted by others. *See, e.g.*, John W. Bagby et al., *How Green Was My Balance Sheet?: Corporate Liability and Environmental Disclosure*, 14 VA. ENVTL. L.J. 225, 338–39 (1995) ("Firm-specific disclosures should have the benefit of rewarding companies with a responsible environmental record, while steering investment away from companies with looming environmental problems."). In particular, explanations for any deviation could themselves provide an important source of new information to the market, allowing investors to evaluate firms based on their quality and content. *See* Seidl et al., *supra* note 54, at 793–94.

[118] Concept Release, *supra* note 5, at 23,927 (identifying aspects of principles-based requirements within Regulation S-K).

[119] The nature of ESG information and the complexity surrounding ESG materiality also point clearly to a principles-based disclosure approach, whether through regulatory guidance or a comply-or-explain disclosure regime, rather than prescriptive "one-size-fits-all" reporting rules.

The need for flexibility is supported by the evidence from the Danish corporate governance code, where firms have opted to explain noncompliance more frequently with respect to CSR matters.[120] Although quantitative metrics for reporting ESG issues are widely available and increasingly standardized, historical data is not widely available, and many ESG risks can only be evaluated through qualitative assessments by firm management. To the extent that ESG information reflects risk, it will often require management predictions and estimates that are forward-looking. The fact that ESG materiality is a relatively new consideration for corporate boards and their advisors also points to the need for flexible regulatory responses. Explanations for deviations from disclosure or governance best practices therefore provide an important benefit from a regulatory standpoint beyond the efficiencies for the firm, since the ability to explain why a specific disclosure is not material reduces the risk that investors will be flooded with immaterial information.[121]

2. Fit with the U.S. Institutional Framework

The relatively successful experience of the U.K. and other developed capital markets also suggests that the U.S. could be a receptive market for broader adoption of comply-or-explain approaches to disclosure. As one commentator has noted, several features of the U.K. capital markets in the 1990s when the Cadbury Report was first released—"dispersed share ownership, the presence of institutional investors, strong financial markets and an influential financial press"—made it particularly well-suited to a self-regulatory or market-driven approach like comply or explain.[122] With the possible exception of share ownership, which has become relatively more concentrated in the U.S. but relatively more fragmented in the U.K. over time,[123] these features are common to the U.S. as well. Moreover, both the U.K. and the U.S. share a common law legal tradition and a preference for reliance on self-regulation and private ordering. One explanation for the more limited success of comply or explain in continental Europe comes from the stakeholder-oriented nature of many

[120] *See* Rose, *supra* note 86, at 7 (finding that 21% of companies deviated from compliance with a legal mandate to adopt a CSR policy).

[121] *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448–49 (1976) (expressing concern that over-disclosure of nonmaterial information might allow management "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking").

[122] Abma & Olaerts, *supra* note 60, at 287–88.

[123] Both jurisdictions are characterized by dispersed ownership. *See* Brian R. Cheffins, *The Stewardship Achilles' Heel*, 73 MOD. L. REV. 1004, 1006, 1017–20 (2010) (identifying fragmented ownership as a barrier to implementation of the U.K. Investor Stewardship Code). *But see* MATTEO TONELLO & STEPHEN RABIMOV, THE CONFERENCE BD., THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 22 tbl.10 (2010) (reporting increasing share ownership concentration among large U.S. listed firms).

European markets and limitations in some jurisdictions on active shareholder monitoring. In contrast, shareholder activism in the U.S. is a palpable force on both governance and broader ESG issues, and so long as investors recognize the materiality of the ESG information covered by any future disclosure rules, investor passivity may be less of a concern than in other markets with different market characteristics and corporate governance traditions.

Of course, unlike other comply-or-explain regimes that rely almost exclusively on private (i.e. shareholder or market) enforcement, the proposed comply-or-explain regimes, if adopted in the U.S., would also be backed by the enforcement authority of the SEC, private litigation, and, perhaps, by stock exchange listing rules. A credible threat of litigation or regulatory penalties for deficient or missing explanations, or those that render disclosure misleading, offers a corrective to the weak enforcement of the obligation to explain deviations in jurisdictions that rely exclusively on shareholder monitoring and market discipline.[124]

3. Compliance & Cost Efficiencies

With regard to ESG issues, a comply-or-explain approach to disclosure allows regulators to identify core issues they believe to be material to all firms, while also relieving the compliance burden for firms that determine such issues are not in fact material to them. The potential cost efficiencies of comply or explain are important, since Congress has directed the SEC to undertake its ongoing comprehensive review of current reporting requirements in order to reduce the compliance burden for public companies.[125] Unfortunately, there is no clear evidence from other jurisdictions about the relative costs of firm compliance under comply-or-explain and prescriptive-disclosure models. In part, this is because other capital markets that have adopted nonfinancial disclosure rules have done so too recently to have generated evidence about their cost-effectiveness relative to their impact.

However, compliance costs should be lower under comply-or-explain reporting than under a mandatory regime, because firms have the option to deviate from best practices that might be immaterial or may prove inefficient. To the extent that the particular ESG best practices, such as GHG emissions reporting, are already widely adopted in the market, the compliance costs associated with requiring such disclosures within financial reports may not be significant. In contrast, the conflict minerals disclosures under Dodd-Frank have been criticized for forcing companies to

[124] *See supra* note 61 and accompanying text (discussing the challenge of investor passivity in Europe).

[125] Jumpstart Our Business Startups Act (the "JOBS Act"), Pub. L. No. 112-106, § 108, 126 Stat. 306, 313 (2012) (requiring the SEC to review Regulation S-K to reduce the cost burden on emerging growth companies); *see also* SEC, *supra* note 110, at 104 (concluding that all issuers would benefit from modernizing the disclosure regime).

implement monitoring systems to disclose what may in fact be immaterial reputational or legal risks. One caveat, here, as noted in Section C below, is that comply-or-explain reporting is not likely to displace voluntary ESG reporting, and so firms will still bear the costs of multiple ESG reporting regimes.

4. Regulatory Efficiency & Reflexive Regulation

Even if issuers' disclosure costs do not decline markedly in the near term, comply-or-explain reporting also offers potential efficiencies for the SEC in an environment where new ESG disclosure mandates are almost certain to meet with stiff resistance from some issuers and from the courts. Based on recent (and much-maligned) cases in the D.C. Circuit, the SEC recognizes that it must justify any new disclosure rules on an economic cost-benefit analysis.[126] This task may be easier if the new disclosures are no more costly than existing voluntary reporting or in fact *reduce* issuer reporting costs, and the flexibility of comply-or-explain disclosure may also make the types of rules proposed here easier to justify from a cost standpoint. The SEC will also be better positioned to establish the benefits of the new rules if, as proposed here, those benefits are directly tied to the SEC's statutory authority without reference to separate public policy goals that may be seen as having a more tenuous connection to investor risk and return or systemic risk. Because issuers are not in fact obligated to make particular disclosures under a comply-or-explain regime, such rules might also survive a potential constitutional challenge that the new rules constitute compelled commercial speech, an argument that caused the D.C. Circuit to invalidate part of the conflict minerals disclosure rules.[127]

To the extent that firms' explanations for any deviations are adequate and informative, comply or explain may also create a flexible mechanism for responsive regulation. As Seidl et al. observe in their review of reporting practices in the U.K. and Germany, explanations provide a useful signaling mechanism that can contribute to the dynamism of the reporting regime. Different types of explanations can provide important information to the SEC and other policymakers that can affect allocation of enforcement resources, aid evaluation of the effectiveness of the disclosure rules themselves, and identify areas where the code principles are at odds with other regulations in a way that may not have been

[126] *See* Concept Release, *supra* note 5, at 23,917 (as applied in recent cases, this will require the SEC to establish that the expected benefits of any new reporting rules outweigh the expected compliance costs); *see also* John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 913–20 (2014) (analyzing these cases).

[127] Nat'l Ass'n of Mfrs v. SEC, 800 F.3d 518, 530 (D.C. Cir. 2015).

initially appreciated when the codes were introduced.[128] Observed areas of non-adoption or those attracting a high rate of compliance by explanation, as well as specific concerns that emerge through "reasoned" or "principled" explanations themselves, may point to a need to revise the code to facilitate broader adoption or may identify alternative best practices that could inform future policy changes.[129]

C. *Responding to the Limits of Comply or Explain*

Notwithstanding the many potential benefits of adopting any new ESG disclosures on a comply-or-explain basis, it is important also to acknowledge here what comply-or-explain disclosure will not change. First, a soft regulatory comply-or-explain approach will not satisfy those who believe that current reporting rules already ensure the disclosure of all material ESG information necessary to investment analysis and do not see a need for further ESG reporting within the financial statements. In addition, the necessary materiality limits on ESG disclosure for financial reporting purposes means that companies will continue to produce separate ESG disclosures for other stakeholders that overlap with financial reporting but do not meet the materiality standard established in *TSC Industries*. While voluntary reporting will continue to address corporate impacts on stakeholders that may not pose a quantifiable risk of financial harm to the firm, materiality limits may make ESG disclosure within financial reporting a weaker tool to address public policy goals and limit the potential comparability of financial and sustainability reporting.[130] Finally, compliance by explanation may not offer a cheaper, simpler alternative to issuers or facilitate comparable disclosures for investors. Despite these limits, however, by moving companies toward best practices, comply-or-explain approaches may in time reduce the costly redundancies between voluntary and mandatory reporting, and incorporating ESG reporting into annual reports even to a limited extent may make that information more accessible to investors.

In addition, some commentators have suggested comply or explain may be less effective than direct mandatory rules if the ultimate goal is to target specific corporate behavior or if in practice nearly all firms will

[128] *See* Seidl et al., *supra* note 54, at 811–14 (noting how explaining deviations contributes to reflexive learning, which can inform future regulation and also legitimize those deviations). *But see* Cankar et al., *supra* note 101, at 523–25 (discussing Slovenia as an example of the failure of reflexive self-regulation).

[129] Seidl et al., *supra* note 54, at 811–14 (categorizing types of explanations).

[130] *See* Ruth Jebe, *Sustainability Reporting and New Governance: South Africa Marks the Path to Improved Corporate Disclosure*, 23 CARDOZO J. INT'L & COMP. L. 233, 252–53 (2015) (observing that linking financial reporting concepts of materiality to ESG reporting requirements limits mandatory disclosure regimes' power to address public policy goals).

comply by adopting best practices.[131] There is also mixed evidence as to whether investors and the market pay attention to the quality of explanations, and what the effect of a justifiable, well-explained deviation from the stated practices is on firm value.[132] The SEC should consider these critiques while considering the potential benefits of offering a flexible comply-or-explain model, even if the flexibility is under-utilized.

A further challenge to the current proposal is that any new disclosure rules addressing sustainability or other ESG issues are almost certain to face legal challenge. It is unclear at present how the D.C. Circuit would resolve a dispute contesting disclosure rules that are designed in part to achieve a direct regulatory goal, such as improving how companies monitor their sustainability practice and risk. Comply-or-explain approaches have been adopted by governments worldwide not only to improve the quality and reliability of information available to the market but also to move companies toward better corporate governance, risk management, and, in many cases, transparency for corporate impacts on stakeholders. Such goals are explicit in every voluntary ESG reporting regime, in the corporate governance codes described here, and also in the 2014 EC Transparency Directive.[133] However, as noted earlier, the SEC may be unwilling to adopt disclosure rules for a direct regulatory purpose. Notably, nearly all the corporate governance reforms that have been incorporated into federal securities law in recent years have been initiated by Congress, either in Sarbanes-Oxley or in the Dodd-Frank Act.

However, if, as proposed here, ESG disclosure rules introduced on a comply-or-explain basis are directly justified on the basis of their financial materiality or their connection to broader market stability, they will be more likely to withstand legal attack. The SEC has also determined that it can permissibly engage in rulemaking to benefit investors within its statutory authority, even if so doing also indirectly benefits interested stake-

[131] *See, e.g.*, Rodrigues & Stegemoller, *supra* note 73, at 64 (recommending targeted disclosure rules over the Sarbanes-Oxley § 406 comply-or-explain approach to corporate ethics codes).

[132] Some studies find that market prices do not react to information provided in explanations of deviation and suggest that investors and market analysts may ignore the content of explanations. *See, e.g.*, Arcot et al., *supra* note 66, at 193–94, 198–99. However, another study found that compliance by explanation among Canadian firms resulted in higher firm value and return on investment to shareholders. Luo & Salterio, *supra* note 100, at 475.

[133] *E.g.*, Council Directive 2014/95, *supra* note 48. In the European Union, transparency is explicitly identified as a regulatory tool. Klaus J. Hopt, *Corporate Governance in Europe: A Critical Review of the European Commission's Initiatives on Corporate Law and Corporate Governance*, 12 N.Y.U. J.L. & BUS. 139, 202–05, 202 n.263 (2015) (referencing examples from the EU Commission's 2012 Action Plan on European Company Law and Corporate Governance).

holders.[134] As noted earlier, the flexibility inherent in the comply-or-explain model may also help to insulate any new disclosure rules from some of the arguments that have stymied other new disclosure rules in recent years.

V. CONCLUSION

Global regulators, international organizations, and investor coalitions are expressing growing concern that markets lack access to material nonfinancial information that is decision-useful. Empirical findings on ESG materiality also suggest that the historic divide between voluntary sustainability reporting and mandatory financial reporting is increasingly obsolete. In this context, the SEC confronts new questions about the adequacy of the current disclosure regime and the need to respond flexibly to emerging risks that are material to investors, may become material over time, or could threaten the broader health and stability of the capital markets. Issuers and regulators stand to gain better insights in the coming years from the implementation of the European Transparency Directive, which begins in 2017, and when research is available on the effectiveness of newer ESG reporting rules in other leading markets such as Hong Kong and Singapore. Even assuming that consensus can be reached about the benefits of new ESG disclosure, determining how this should be accomplished given the diversity of ESG issues and the varying evidence on their materiality is not easy. For now, the evidence from comply-or-explain-based corporate governance codes suggests that they offer a useful alternative to both broad-brush ESG reporting mandates on the one hand, and voluntary disclosures that have proven less useful to financial investors on the other.

[134] *See* 2010 Climate Guidance, *supra* note 3, at 6296 (describing the indirect consequences of regulation, including decreased demand for goods that produce greenhouse gas emissions).

Appendix A: Comparative Studies of Comply or Explain

Study	Publication Date	Jurisdiction	Data & Scope	Data Year	Findings
Dirk Akkermans et al., *Corporate Governance in the Netherlands: An Overview of the Application of the Tabaksblat Code in 2004*, 15 Corp. Governance 1106 (2007).	2007	Netherlands	Analysis of 120 code provisions from annual reports of 150 Dutch listed companies	2004	High level of Code compliance ranging from 69–96% depending on the provision and positively related to company size; high similarity of explanations (at 1110).
Sridhar Arcot, et al., *Corporate Governance in the UK: Is the Comply or Explain Approach Working?*, 30 Int'l Rev. L. & Econ. 193 (2010).	2010	United Kingdom	Analysis of annual reports of 245 nonfinancial companies on the FTSE 350	1998–2004	Over 50% of nonfinancial firms on the FTSE 350 fully compliant by end of 2004, but boilerplate explanations common; nearly 20% of deviating firms providing no explanations. Code adoption, but not explanation, quality improves over time, with higher compliance for FTSE 100 firms (at 196, 199). Market does not appear to reward compliance (at 199).

Reints Abma & Mieke Olaerts, *Is the Comply or Explain Principle a Suitable Mechanism for Corporate Governance Throughout the EU?: The Dutch Experience*, 9 Eur. Company L. 286 (2012).	2012	Netherlands	Analysis of 100 listed firms' annual reports	2009	Majority of deviating firms provided generic explanations or no explanation at all (at 293).
Nina K. Cankar et al., *The Reflexive Properties of Corporate Governance Codes: The Reception of the 'Comply-or-Explain' Approach in Slovenia*, 37 J.L. & Soc'y 501 (2010).	2010	Slovenia	Analysis of annual reports for all 26 companies publicly traded on the Slovenian stock exchange (LJSE) as of May 31, 2006	2004, 2006	Surprising uniformity in compliance strategies, types of deviations, and explanations for deviations; low reporting quality, limited number of adequate explanations (at 524–25).
Caspar Rose, *Listed Firms' Level of Stakeholder Transparency—The Comply or Explain Evidence from the Danish Corporate Governance Code*, 10 Int'l J. Bus. Sci. & Applied Mgmt. (2015); Caspar Rose, *Firm Performance and Comply or Explain Disclosure in Corporate Governance*, 34 Eur. Mgmt. J. 202 (2016).	2015; 2016	Denmark	Analysis of 9 corporate governance practices (6 shareholder-oriented, 3 stakeholder-oriented) from annual reports and websites of all 155 companies on the Nasdaq OMX Copenhagen	FY2010	Total 91% compliance (82% by adoption and an additional 9% by explanation); 4.5% explain poorly (Rose (2015) at 5; Rose (2016) at 210). Finds a positive relationship between financial performance (ROE/ROA) and the level of disclosure on certain governance measures but not on others (Rose (2016) at 217–18).

Reggy Hooghiemstra & Hans van Ees, *Uniformity as Response to Soft Law: Evidence from Compliance and Non-Compliance with the Dutch Corporate Governance Code*, 5 Reg. & Governance 480 (2011).	2011	Netherlands	Analysis of 120 provisions of Dutch corporate governance code in annual reports of 126 listed Dutch firms (93% of total)	2005	Overall high compliance rate but boilerplate explanations for deviations. Finds firm size positively correlated with compliance by adoption (at 493–94).
Hana Horak & Nada Bodiroga-Vukobrat, *EU Member States' Experiences with the 'Comply or Explain' Principle in Corporate Governance*, 7 Croat. Y.B. Eur. L. & Pol'y 179 (2011).	2011	Croatia	Report of which corporate governance code, if any, was adopted by 265 listed firms on the Zagreb exchange	2010	63% comply by applying the Croation Corporate Governance Code, with 95% of those reporting full compliance and 6% providing an explanation of deviation (at 198).
Yan Luo & Steven E. Salterio, *Governance Quality in a "Comply or Explain" Governance Disclosure Regime*, 22 Corp. Governance 460 (2014).	2014	Canada	Analysis of 47 corporate governance indicators in annual reports and proxy statements of 655 Canadian listed firms	2006	13% of firms fully compliant across all measures, either by adoption or explanation (at 466).
Ian MacNeil & Xiao Li, *"Comply or Explain": Market Discipline and Non-Compliance with the Combined Code*, 14 Corp. Governance 486 (2006).	2006	United Kingdom	Analysis of 11 provisions of the Combined Code of Corporate Governance for 18 companies on the FTSE 100	2004	Less than half of the companies adopt the Code in full; many explanations are uninformative (at 489).

Michail Nerantzidis, *Measuring the Quality of the "Comply or Explain" Approach: Evidence from the Implementation of the Greek Corporate Governance Code*, 30 Managerial Auditing J. 373, 373 (2015).	2015	Greece	Content analysis of corporate governance statements and web disclosures of sample of 144 listed companies on the Athens Stock Exchange, assessing 52 variables	2011	Low degree of compliance by conduct (35%), lower degree of compliance by explanation; of remaining 65% not complying by conduct, 41% give no explanation at all (at 385).
Steven E. Salterio et al., *Canadian Evidence of Adherence to "Comply or Explain" Corporate Governance Codes: An International Comparison*, 12 Acct. Persp. 23 (2013).	2013	Canada	Analysis of 16 corporate governance principles for 742 Canadian public companies' annual reports & proxy statements, 1334 listed Australian companies	2006–2007 fiscal year end (after June 2006)	82% comply by adopting best practices and 4% by explanation (of these, 39% of firms show complete compliance); 86% average compliance rate for firms (most through adopting best practices).
Steven E. Salterio et al., *Canadian Evidence of Adherence to "Comply or Explain" Corporate Governance Codes: An International Comparison*, 12 Acct. Persp. 23 (2013).	2013	Australia	Analysis of 16 corporate governance principles for 742 Canadian public companies' annual reports & proxy statements, 1334 listed Australian companies	June 2006–2007 fiscal year end	70% complied by best practices and 20% by explanation (74% complete compliance) (at 26, 39).
David Seidl et al., *Applying the 'Comply-or-Explain' Principle: Discursive Legitimacy Tactics with Regard to Codes of Corporate Governance*, 17 J. Mgmt. &	2013	United Kingdom	Analysis of 48 provisions of the UK Combined Code in annual reports of 130 listed firms (all firms on the FTSE 100 & 30 firms on	CY2006	48% of firms comply by explanation, particularly small firms; explanations most common for controversial standards (independent directors, board

Governance 791 (2013).			the FTSE 250)		committee composition). Absolute number of deviations (4.7%), inversely related to firm size. 40% of explanations deficient (at 799–800, 807).
David Seidl et al., *Applying the 'Comply-or-Explain' Principle: Discursive Legitimacy Tactics with Regard to Codes of Corporate Governance*, 17 J. Mgmt. & Governance 791 (2013).	2013	Germany	Analysis of 82 provisions of the German Cromme Code in annual reports of largest 130 listed firms (DAX30, MDax, SDax)	CY2006	86% of firms comply by explanation, particularly small firms. Absolute number of deviations (6%) inversely related to firm size; well over 50% of explanations deficient (at 799–800, 807).
Axel v. Werder et al., *Compliance with the German Corporate Governance Code: An Empirical Analysis of the Compliance Statements by German Listed Companies*, 13 Corp. Governance 178 (2005).	2005	Germany	Analysis of code compliance declarations for 408 listed firms on Frankfurt Stock Exchange.	2002	High degree of code compliance; compliance level increases with firm size; code adoption causes changes in corporate practice (at 181).

Appendix B: Sample Explanations of Code Deviations[135]

Categories of Explanation	Sub-categories of Explanation	Examples
Lack of justification—Company discloses deviation without providing reasons	Pure disclosure	"There was no insurance cover in place in respect of legal action against the Company's directors until 9 June 2005 [as required by German Code A.1.5]." (Alliance Trust)
	Description of alternative practice	"The structure and level of the Executive Board compensation is reviewed and determined by the Supervisory Board's General Committee instead of the entire Supervisory Board [as required by German code provision 4.2.2 Para1(1HS)]. The General Committee informs the Supervisory Board as a whole on the respective results." (Adidas-Solomon)
	Empty justification	"We believe that due to the successful work of the supervisory board and its committees in the past, an additional compensation for the members of the committee [in compliance with Section 5.4.7, paragraph 2 of German code] is not necessary." (Adidas-Salomon)
Context-specific justification—Company justifies deviation with reference to its specific situation		"At the moment, we do not plan to change the current compensation system [to comply with German code provision 5.4.7 para. 2,S1], since forms of payment related to company performance are unusual in our particular competitive environment." (WCM)
Principled justification—Company justifies deviation with reference to problems with the code provision itself	Ineffectiveness/ inefficiency of code provision	"Disclosure of individual compensation for each member of the Management Board, required by clause 4.2.4, sentence 2, in our view limits the structuring of compensation in such a way as to distinguish individual performance and responsibility." (Fresenius)
	Conflicts with law or societal norms	"The introduction of performance related payment for members of the Supervisory Board [as requested by German code provision 3.3.10] is put on hold, since there are currently concerns regarding the legality of performance related payments." (EM TV)

[135] These examples are selected from Seidl et al., *supra* note 54, at 816–23 (examining annual reports from listed firms in the U.K. and Germany in 2006). Seidl et al.'s study further subdivides some of these categories and offers additional examples of each category.