Making Non-Financial Information Count:
Accountability and Materiality in Sustainability Reporting

Chiara Mosca* and Chiara Picciau**

Abstract— *National and international lawmakers are increasingly focusing on sustainability reporting as a way to foster socially and environmentally responsible corporate conduct. Within the European Union, Directive 2014/95/EU has introduced reporting obligations for certain large enterprises on a variety of non-financial issues. Non-Financial disclosure is, however, just one of the legal strategies that the European lawmaker has put in place to foster sustainability. The European regulatory framework aims, in fact, at using shareholders and their monitoring power as a way to stir corporate behavior. Since corporate boards are accountable to shareholders only, if investors and financial intermediaries start paying attention to social and environmental issues in their investment decisions, corporate conduct should adjust accordingly. The key tool that makes this mechanism work is non-financial disclosure, which provides investors and market operators with the data to make informed, socially and environmentally responsible decisions. The content of the disclosure is significantly shaped by the notion of materiality, which has been traditionally employed to determine which financial information companies should disclose. This paper argues, however, that the concept of materiality in non-financial disclosure cannot and should not be a mere duplication of materiality in accounting, auditing and financial markets regulation. The relevant benchmark to assess materiality remains the "reasonable investor", but for the purposes of non-financial disclosure the reasonable investor pays attention to the long-term risks and opportunities of sustainability policies and issues. As a result, we advocate for a forward-looking and investor-based criterion in order to determine whether the disclosure enables to understand the impact of the company's activity on the environment, society and relevant stakeholders. This should lead to a more narrative and consequence-oriented reporting on the non-financial issues on which the company has, or is likely to have, the greatest impact.*

Electronic copy available at: https://ssrn.com/abstract=3536460

Table of Contents

I. INTRODUCTION
1. Corporate Social Responsibility (CSR) and Sustainability in the EU Action Plan: A New Role for Corporations?

II. LEGAL STRATEGIES: DEALING WITH EXTERNALITIES
1. Leveraging on Corporate Governance Accountability Mechanisms to Foster Sustainability
2. The SHRD II and the Engagement of Institutional Investors
3. The MiFID II: How to Integrate ESG Considerations into Investment Processes
4. The Role of Non-Financial Disclosure: Enhancing Shareholder Monitoring

III. MATERIALITY IN NON-FINANCIAL DISCLOSURE
1. The Origins of the Concept: Materiality in Accounting and Auditing
2. Financial Markets Regulation and Materiality
3. Non-Financial Disclosure and Materiality
   a. Do We Need a New Understanding of Materiality in Non-Financial Disclosure?
   b. What Role for Stakeholders?
   c. A Few Examples of Materiality Assessments in Action

IV. CONCLUSIONS

* * *

I. INTRODUCTION

"What are companies for?" is the title and front page of a recent issue of *The Economist*,[1] which makes suddenly perceptible the long-standing, fascinating and evanescent debate on the role of corporations vis-à-vis their customers, workers, suppliers, communities, and society more generally.

In recent times, CEOs and corporate directors of many European companies have been struggling to find an answer to this very same question. If they were not already sensitive to social and environmental issues, they

* Associate Professor in Business and Company Law, Bocconi University, Milan, Italy.
** Post-Doctoral Research Fellow in Business and Company Law, Bocconi University, Milan, Italy.

[1] THE ECONOMIST, Aug. 24-30, 2019.

Electronic copy available at: https://ssrn.com/abstract=3536460

definitely became so after the entry into force of Directive 2014/95/UE,[2] which mandates the disclosure of "non-financial and diversity information by certain large undertakings and groups".

The Directive has prompted the directors of big corporations to enlarge their managerial vision beyond shareholder interests[3] and, compared to the traditional corporate governance paradigm, appears a real novelty. The approach of the Directive and the European Commission's Action Plan "Financing Sustainable Growth" of 8 March 2018[4] seem, in fact, to imply that non-shareholder interests can and should be taken into consideration by the board of directors in the exercise of its duties. These interests may include the needs of society as a whole, such as protecting the environment or promoting equality, as well as those of local communities, employees and other relevant stakeholders.

At a closer look, however, the new provisions on non-financial disclosure do not entail a full shift towards corporate social responsibility (CSR) or towards a stakeholder-oriented theory of corporate governance. The Directive requires reporting on a variety of non-financial issues under a comply or explain approach, but it does not contain any provision that alters the directors' mandate and fiduciary duties as traditionally understood. In other words, it does not require, implicitly or explicitly, the board of directors to take stakeholder interests into consideration when making business decisions, nor does it directly postulate that corporations must embed environmental or social concerns in their policies and strategies. Apparently, it simply requires that they inform the public on whether they

---

[2] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, 2014 O.J. (L 330) 1 [hereinafter "Directive 2014/95/EU", the "Non-Financial Disclosure Directive", or simply the "Directive"].

[3] Non-financial disclosure is mandatory for big enterprises: namely, "public-interest entities exceeding on their balance sheet dates the criterion of the average number of 500 employees during the financial year". *See* art. 19a, para. 1, of Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC, 2013 O.J. (L 182) 19 [hereinafter "Directive 2013/34/EU"]. Art. 19a was introduced by the Non-Financial Disclosure Directive. The non-financial disclosure obligations also apply to groups exceeding the same threshold on their balance sheet, making it mandatory for parent undertakings to prepare consolidated non-financial reports. *See* Directive 2013/34/EU art. 29a, as amended by Directive 2014/95/EU.

[4] *Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions. Action Plan: Financing Sustainable Growth*, COM(2018) 97 final (Mar. 8, 2018) [hereinafter the "Action Plan"].

Electronic copy available at: https://ssrn.com/abstract=3536460

have done so and how. One might thus consider the reach of the new non-financial disclosure obligations fairly limited. After all, companies could simply disclose that they do not have a policy on the specific issue and would still be compliant with the Directive.[5]

The cultural revolution brought by the Directive may, however, be fully appreciated considering that the new wave of non-financial corporate information adds to the traditional set of financial disclosure obligations in a comprehensive reporting system aimed not so much at fostering stakeholder engagement, but first and foremost at promoting shareholder commitment towards sustainability. The Directive is, in fact, a piece—arguably, the pivotal piece—of a more complex set of legal strategies that leverage on directors' accountability to shareholders to promote long-termism and sustainability.

As known, financial information enables shareholders and investors to assess the company's performance and to monitor directors and managers. From a market perspective, making financial performance and business trends easily understandable can effectively reduce the cost of gathering information and raising new capital for investment and growth.[6] Moreover, on the basis of such knowledge, shareholders can take well-grounded decisions, especially regarding the appointment and removal of the company's directors.[7]

Following this path, the worldwide debate on corporate governance of the last decade has called for shareholders to play an increasingly active role by exercising their voting rights and creating a constructive and on-going relationship with the board of directors.[8] Corporate governance continues to

---

[5] Directive 2013/34/EU arts. 19a, para. 1, and 29a, para. 1, as amended by the Non-Financial Disclosure Directive.

[6] *See, e.g.*, Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81, 93-96 (2007); David Easley & Maureen O'Hara, *Information and the Cost of Capital*, 59 J. FIN. 1553 (2004); Richard Lambert, Christian Leuz & Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, 45 J. ACCT. RES. 385 (2007).

[7] *Cf.* Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 L. & CONTEMP. PROBS. 113, 116-18 (1999); Giovanni Strampelli, *The EU Issuers' Accounting Disclosure Regime and Investors' Information Needs: The Essential Role of Narrative Reporting*, 19 EUR. BUS. ORG. L. REV. 541, 560-63 (2018) (discussing the "governance" or "stewardship function" of financial statements).

[8] *Cf.* Jill E. Fisch & Simone M. Sepe, *Shareholder Collaboration* (European Corporate Governance Institute (ECGI) Law Working Paper No. 415/2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3227113 (arguing that activist shareholders and corporate insiders are increasingly engaging in a collaborative dialogue, rather than in confrontation and conflict); Gaia Balp & Giovanni Strampelli, *Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs* (Bocconi Legal Stud. Res. Paper No. 3449989, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3449989.

Electronic copy available at: https://ssrn.com/abstract=3536460

stress the importance of empowering the owners of the company vis-à-vis its directors and managers, providing new tools that shareholders may use to perform their monitoring role. The reverse side of this virtuous mechanism is that shareholders (and investors) often look at short-term financial performance, thus hindering directors and managers from pursuing more sustainable goals.[9] In this context, existing accounting and financial reporting standards that focus on the representation of short-term performance significantly divert shareholder attention from long-term results.

This is where the recent regulatory intervention of the European lawmaker comes into play. The new non-financial disclosure regime is the first piece of a more complex regulatory framework, now including Directive 2017/828/EU on the encouragement of long-term shareholder engagement (SHRD II)[10] and some proposals to amend Directive 2014/65/EU on markets in financial instruments (MiFID II),[11] that aims at making shareholders and investors more attentive to social and environmental issues and adopt a long-term perspective with respect to financial performance. If shareholders and prospective investors start basing their investment decisions on sustainability considerations, companies might respond by adopting more sustainable corporate policies and strategies in the first place. This shift entails a more limited goal than CSR, as it does not put society and stakeholder interests on the same level as shareholder concerns, but promises to have durable effects in encouraging sustainable growth.

Our paper discusses how non-financial disclosure represents the core of this mechanism. After looking in Part I at the relationship between CSR and sustainability, Part II of our paper examines the legal strategies employed by the European lawmaker to foster sustainability, considering to what extent the European regulatory framework really shifts the focus of corporate governance from shareholders to other stakeholders. We argue that this is not really the case given that the board of directors is still mainly accountable to the company's shareholders; and this is probably a necessity, since, as several commentators have pointed out, corporate governance

---

[9] *See, e.g.*, LYNN STOUT, THE SHAREHOLDER VALUE MYTH 66-69 (2012); Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 302-310 (2012); Institute for Law and Finance, *Report of the Reflection Group On the Future of EU Company Law* 36-38 (Working Paper Series No. 126, 2011), https://www.ilf-frankfurt.de/fileadmin/_migrated/content_uploads/ILF_WP_126.pdf.

[10] Directive 2017/828/EU of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement [hereinafter "SHRD II"].

[11] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU [hereinafter "MiFID II"]. For the main proposals, *see infra* Part II, para. 3 (especially note 41).

Electronic copy available at: https://ssrn.com/abstract=3536460

cannot properly work when directors are accountable to many masters.[12] Instead, current shareholder-centered accountability mechanisms may be exploited to affect investor preferences, also through the intervention of institutional investors and financial intermediaries, and thus to foster sustainability and long-termism.

Understanding such a complex system of interrelated incentives and duties allows us to come to a different understanding of the role of non-financial disclosure. If shareholders remain the only constituency that may exercise actual influence on the company's decision-making processes, in order for them to exert pressure on corporations towards more sustainable corporate behaviors, they must be able to access the relevant information. Non-financial disclosure and its connected materiality principle intend to bridge this gap.

As Part III of our paper explains, the European regulatory framework makes reference to the traditional concept of materiality to define the content of non-financial disclosure obligations. The materiality principle has been imported from accounting standards, which assume that shareholders are primarily interested in (short-term) financial performance. As such, in its traditional connotation, it does not strictly require directors to communicate non-financial issues and policies, the impact of which is often measurable only in the long run, if at all. This last part of our paper argues, however, that materiality in non-financial disclosure assumes a slightly different meaning, consistently with the legal strategies employed by the European lawmaker to empower socially and environmentally responsible investors. For non-financial information, the benchmark is not simply the "reasonable investor", but a reasonable investor that pays attention to the effects of social and environmental issues and to long-term risks and opportunities. The disclosure thus becomes more forward-looking, attentive to the long-term impact of company choices and policies, and essentially narrative. Finally, Part IV of our paper concludes.

1. Corporate Social Responsibility (CSR) and Sustainability in the EU Action Plan: A New Role for Corporations?

The Directive of 2014 on non-financial disclosure is the first vital tool in the EU landscape "for managing change towards a sustainable global economy

[12] *See* The Council of Institutional Investors, Press release. Council of Institutional Investors Responds to Business Roundtable Statement on Corporate Purpose (Aug. 19, 2019), https://www.cii.org/aug19_brt_response (observing that "accountability to everyone means accountability to no one"); Barnali Choudhury & Martin Petrin, *Corporate governance that 'works for everyone': promoting public policies through corporate governance mechanisms*, 18 J. CORP. L. STUD. 381, 386, 391-92 (2018).

Electronic copy available at: https://ssrn.com/abstract=3536460

by combining long-term profitability with social justice and environmental protection", under the assumption that disclosure "helps the measuring, monitoring and managing of undertakings' performance and their impact on society".[13]

Since its enactment, the EU agenda has significantly widened its scope. The more recent *Action Plan: Financing Sustainable Growth*, presented by the European Commission in March 2018, traces the trajectories that must be followed in various areas of the law to increase the contribution of corporations to "the benefit of the planet and of our society".[14] Such an intrusive mission, which affects companies, financial intermediaries and markets, does not specifically aim at modifying directors' discretion in managing the corporation; in fact, no guidance is given to the board of directors on how to choose among heterogeneous interests, such as shareholders' wealth and the well-being of other stakeholders and constituencies. Even though companies often support several charitable organizations and may take the interests of different stakeholders into account, it is questionable that the board of directors must do so or that it is completely free to decide which altruistic mission to undertake.[15]

The importance of the political agenda announced in the EU Action Plan lies in the recognition of a new role for corporations, and specifically for large corporations. Significantly, however, the Action Plan does not focus on CSR. Instead, it indicates *sustainability* as the ultimate goal of the body of laws that is still under construction in Europe. Linking finance to the global economy, the European institutions intend to meet two urgent imperatives: "(1) improving the contribution of finance to sustainable and inclusive growth by funding society's long-term needs, [and] (2) strengthening financial stability by incorporating environmental, social and governance (ESG) factors into investment decision-making". The Action Plan explains that companies do not sufficiently consider environmental and

---

[13] Non-Financial Disclosure Directive Recital 3.

[14] Action Plan, *supra* note 4, at 2.

[15] In the United States, for example, directors have a duty to pursue the "best interests of the corporation" which may extend beyond shareholder interests: AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (1994). Consistently, the business judgment rule, as a second-guess criterion to assess directors' choices, can generally be considered satisfied even when the board's decision was also driven by concerns about the employees, the community and other constituencies. In the Delaware case law, *see* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955-56 (Del. 1985) (pointing out that directors should consider the effect of takeover bids on the corporate enterprise, including "the impact on "constituencies" other than shareholders (i.e. creditors, customers, employees, and perhaps even the community generally)"). *See also* Virginia Harper Ho, *Enlightened Shareholder Value: Corporate Governance beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 74-75 (2010); Michael E. Porter & Mark R. Kramer, *Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility*, 84 HARV. BUS. REV. 1, 2 (2006).

Electronic copy available at: https://ssrn.com/abstract=3536460

social issues in their investment decisions and that the reason for this indifference is that "such risks are likely to materialize over a long-term horizon". In other words, sustainability requires attention to "environmental and social considerations in investment decision-making" in a long-term perspective, and investor short-termism makes it harder to support sustainable economic growth for the company in a way that will also favorably impact society as a whole. Thus, according to the Action Plan, incorporating environmental, social and governance (ESG) considerations into investment decisions is the key to social growth and a more responsible pursuit of profit.

This seems a different, but not necessarily less disruptive, objective than the enhancement of a more general CSR. The Action Plan does not take a stance on whether consideration of ESG factors requires balancing shareholder interests with non-shareholder concerns or whether European companies should try to take action that exclusively benefits stakeholders. The assumption is that greater attention towards ESG factors by investors will lead to more sustainable business choices, first and foremost for the benefit of the shareholders, and, eventually, to CSR.

The two, in fact, do not perfectly overlap. Charity, for instance, definitely falls within the realm of the traditional CSR initiatives that corporations voluntarily undertake to benefit their communities. However, it is disputable that the non-financial disclosure mandated by the Directive should also cover charitable donations. The Directive introduces the obligation for big undertakings to disclose the policies they pursue in relation at least to "environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters", as well as the "the outcome of those policies".[16] The Action Plan assumes, however, that "taking longer-term sustainability interests into account makes economic sense and does not necessary lead to lower returns for investors",[17] and that "corporate transparency on sustainability issues is a prerequisite to enable financial market actors to properly assess the long-term value of companies and their management of sustainability risks".[18] This implies coordination with the

[16] Directive 2013/34/EU arts. 19a, para. 1, and 29a, para. 1, as amended by the Non-Financial Disclosure Directive.

[17] Action Plan, *supra* note 4, at 2. *Cf.* Ioannis Ioannou & George Serafeim, *Corporate Sustainability: A Strategy?* (Harv. Bus. Sch. Acct. & Mgmt. Unit, Working Paper No. 065, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3312191; Blanaid Clarke, *The EU's Shareholder Empowerment Model in the Context of the Sustainable Company Agenda*, 11 EUR. COMPANY L. 103, 104 (2014).

[18] Action Plan, *supra* note 4, at 3. The relationship between strategic business decisions and socially and environmentally responsible corporate conduct could be, and often is, particularly intricate. Andrew Hill, *The limits of the pursuit of profit*, FINANCIAL TIMES, Sept. 22, 2019, addresses this issue through the case of the highly successful strategy of Danone's CEO who proposed to shift half of the company's products to non-GMO

Electronic copy available at: https://ssrn.com/abstract=3536460

company's profit goals, not neglect. The inclusion of the Directive in the broader context of reforms envisioned by the Action Plan indicates that the disclosure should essentially address how the corporation has decided to manage the opportunities and risks created by ESG factors and how these have been incorporated in its decision-making processes, not all possible CSR initiatives. Non-financial disclosure is, in other words, the first step towards a more complex review of the supply chain of capital, which can divert shareholders' attention from short-term results and drive their interest towards wider social and environmental risks and opportunities for sustainable development.

In this framework, directors should be able to select the ESG issues that are relevant to the long-term profitability of the company and, consequently, disclose the related outcomes. With regards to environmental, social justice and equality concerns, directors should focus their efforts on the areas that are most relevant to their corporation or, alternatively, to their investors, consumers, workers and local communities. Purely altruistic behavior is not in principle excluded, but the board should first and foremost disclose "information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity…".[19]

II. LEGAL STRATEGIES: DEALING WITH EXTERNALITIES

Legal strategies play an important role in achieving specific goals that cannot be reached by market forces alone. Public goals often require legislative intervention to fill in the gap between what economic operators would spontaneously accomplish and the level of commitment that benefits society as a whole. This explains why, despite the incentives for companies to voluntarily disclose their financial results, the optimal level of disclosure (i.e. the level of detail in financial statements, reports or prospectuses) has traditionally been set at a higher threshold by legislative intervention. Public goals regarding the efficient distribution of resources depend on disclosure

ingredients, despite the initial opposition of the other company executives. This strategic shift, which was originally perceived as a potentially costly *ouverture* to environmentalist claims (which argued that it would have improved soil heal and biodiversity), caused not only an increase in prices, but also a significant increase in Danone's market share. It is questionable whether this corporate strategy represents a "sincere (social) purpose" or only a profit-oriented change in the production chain that ends up creating a benefit for the environment, consumers and the company's profitability at the same time. The answer probably is that both are true; and, with the limits of a single observation, it shows the theoretical consistency of the idea that corporations should conduct their business in pursuit of a long-term view that combines profit and attention to society's needs.

[19] Directive 2013/34/EU arts. 19a, para. 1, and 29a, para. 1, as amended by the Non-Financial Disclosure Directive.

Electronic copy available at: https://ssrn.com/abstract=3536460

that enables investors to identify the enterprises with the highest net present value. However, some pieces of information that would be needed to shed light on this are exactly the kind of information that companies would not spontaneously disclose, provided that disclosure may, for example, expose the issuer to the risk of takeovers or signal a profitable business model or opportunity to rival firms.[20]

In the past, compulsory regimes of financial disclosure found justification in the need to reach the socially optimal amount of information to be made publicly available.[21] A similar rationale justifies, among other reasons, a mandatory regime of non-financial disclosure.[22] Information on innovative sustainability policies and practices that have been put in place at a cost would become easily available to competitors, encouraging freeriding and imitative behaviors. More generally, because "information on corporate sustainability practices is—like nearly all forms of information—a public good" and "because firms cannot capture all the benefits of sustainability information disclosures (i.e., it [sic] cannot easily charge other firms for using that information), economic theory predicts that the private sector will underproduce sustainability-related information if left to its own devices".[23] Even more evident is, absent any binding regulation, the incentive for corporations to omit the representation of the negative externalities caused by their activities to the stakeholders, the environment and society.

In this context, mandatory sustainability reporting aims at reducing a market failure. This is particularly the case when negative externalities due to non-sustainable practices are not shown in the company's balance sheets and reports. Companies do not internalize the costs of their conduct and the market is not able to distinguish companies that have put in place sustainable strategies from companies that have not. As a consequence, the

---

[20] *See, e.g.*, MARCO VENTORUZZO, LA RESPONSABILITÀ DA PROSPETTO NEGLI STATI UNITI D'AMERICA TRA REGOLE DEL MERCATO E MERCATO DELLE REGOLE 138-146 (2003).

[21] *See, e.g.*, Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) (comparing federal mandatory disclosure to a system of regulatory competition among states on disclosure regimes); Fox, *supra* note 7 at 118-20, 122 (observing that managers might not voluntarily disclose information that might suggest the existence of a breach of fiduciary duties and that mandatory disclosure in securities offerings includes information that directors would rather not produce); Ferrell, *supra* note 6 (discussing the socially desirable effects of mandatory disclosure); H. I. Wolk & M.G. Tearney, *The Economics of Financial Reporting Regulation*, *in* ACCOUNTING THEORY 88-99 (1997) (discussing the arguments in favor and against regulating financial reporting).

[22] *See generally* Daniel C. Esty & Quentin Karpilow, *Harnessing Investor Interest in Sustainability: The Next Frontier in Environmental Information Regulation*, 36 YALE J. ON REG. 625, 663-70 (2019); Allison M. Snyder, *Holding Multinational Corporations Accountable: Is Non-Financial Disclosure the Answer*, 2007 COLUM. BUS. L. REV. 565, 606.

[23] Esty & Karpilow, *supra* note 22, at 663-64.

Electronic copy available at: https://ssrn.com/abstract=3536460

latter are not penalized even if they behave in a non-sustainable manner.[24] Mandatory non-financial disclosure and integrated reporting stimulate companies to identify and make public all the major risks that depend on the impact of their business on the environment and society[25] and to adopt non-financial key performance indicators that are specific to the company's activity.[26] As some researches have shown, companies whose business model takes into due consideration such adverse impacts on society prove to be more efficient and profitable than competitors that do not care about these aspects.[27] Interestingly, these results seem to be achieved mostly thanks to adjustments in the organizational structure and risk assessment methodologies, which provide evidence of the reliability and conscious attitude of the entity towards sustainability issues. This shows that enhanced non-financial disclosure might favor more sustainable practices and might help reduce negative externalities as a result.

Market inefficiencies arise, by contrast, when the market does not recognize or reward the virtuous behavior of sustainable corporations that succeed in preventing the negative effects of their activities and/or offer a positive contribution to the environment and society.[28] So long as these positive impacts are not reflected in the company's financial statements and reports, investors are unable to appreciate sustainability efforts, cannot distinguish "sustainability leaders" from "laggards",[29] and cannot contribute to lower the cost of capital of the company involved.

Greater and better information on the positive impact of sustainability policies and practices is therefore just as important as information on the negative externalities created by the business. Nevertheless, it might not be sufficient to produce durable effects of socially responsible growth. In this respect, the European Commission is aware that non-financial disclosure alone, being the first legal strategy that became law, might not be enough to steer market forces towards more sustainable investments, unless other legal mechanisms contribute to "nudge" market operators in the same direction. Accordingly, as we will explain in the following paragraphs, the legal

---

[24] Steve Waygood, *How do the capital markets undermine sustainable development? What can be done to correct this?*, 1 J. SUSTAINABLE FIN. & INV. 81, 82 (2011).
[25] With regards to the inclusion of information on the adverse impacts of the company's activity in non-financial reports: *see* Commission Communication, Guidelines on non-financial reporting (methodology for reporting non-financial information), 2017 O.J. (C 215), 1, para 3 [hereinafter the "Guidelines"].
[26] *See* Directive 2013/34/EU arts. 19a, para. 1, lett. (e), and 29a, para. 1, lett. (e), as amended by the Non-Financial Disclosure Directive. *See also* the Guidelines, *supra* note 25, para. 4.5.
[27] *See* Mozaffar Khan, George Serafeim & Aaron Yoon, *Corporate Sustainability: First Evidence on Materiality*, 91 ACCT. REV. 1697, 1699 (2016)
[28] Waygood, *supra* note 24, at 82.
[29] *See* Esty & Karpilow, *supra* note 22, *passim*.

Electronic copy available at: https://ssrn.com/abstract=3536460

strategies that are currently under construction in Europe build on disclosure in order to affect the conduct of institutional investors and financial intermediaries, making them advocates for more sustainable corporate policies and strategies. The full picture however still depends on the commitment of corporations to provide *material* information in their non-financial reports.

1. *Leveraging on Corporate Governance Accountability Mechanisms to Foster Sustainability*

Since the power to monitor corporate directors and managers ultimately rests with the shareholders, whether business decisions actually enhance sustainability also depends on their commitment toward such a relatively new approach in governance. Shareholders (specifically institutional investors) may exert significant influence over corporate decision-making; thus, whether corporate policies benefit the society largely depends on whether these shareholders intend to use their voice and power to this end.[30] The attention that the corporation will devote to sustainability depends on how much this will attract new investors. Moving from this assumption, the following two paragraphs highlight the main legal strategies that have been adopted or proposed in Europe to shift the demand side of the market toward more sustainable investments. The first EU legal strategy mainly focuses on fostering investor awareness of sustainability issues and goals and, consequently, on stirring financial resources in this direction. More specifically, investors should integrate ESG factors in their investment decisions and take them into account in the exercise of their monitoring task. As Recital 14 of the SHRD II explains, "[g]reater involvement of shareholders in corporate governance is one of the levers that can help improve the financial and non-financial performance of companies, including as regards environmental, social and governance factors, in particular as referred to in the Principles for Responsible Investment, supported by the United Nations." The second strategy, still in the form of a proposal, is aimed at involving financial intermediaries in the process that leads to the inclusion of ESG factors into investments decisions. This strategy will require a review of the way in which, according to the MiFID II framework, banks and other financial intermediaries provide investment services—investment advice and portfolio management, in particular—to their clients.

2. *The SHRD II and the Engagement of Institutional Investors*

[30] Harper Ho, *supra* note 15, at 80, 98.

Electronic copy available at: https://ssrn.com/abstract=3536460

The SHRD II does apparently very little to serve as the appropriate vehicle to promote sustainability.[31] In fact, if we limit the analysis to its text, it merely calls on institutional investors to "develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy", giving attention to "how they monitor investee companies on relevant matters, including… non-financial performance and risk,… social and environmental impact and corporate governance…".[32] Institutional investors that do not have an engagement policy should simply give a clear and reasoned explanation of why they have chosen not to comply with the requirement. In case they do have a policy, they should publicly disclose, on an annual basis, its content and how it has been implemented in practice.

At first sight, the disclosure requirement, which includes in addition to ESG factors other relevant topics of possible engagement, appears no more than an implicit duty imposed on institutional investors. Considering that the disclosure requirement operates, once again, under a comply or explain approach, the idea that institutional investors in listed companies could become watchdogs on behalf of civil society seems to be no more than wishful thinking. At a closer look, however, three main arguments support a more positive assessment of the potential impact of the SHRD II for sustainability goals.[33]

First, the SHRD II focuses on institutional investors[34] because they hold most of the shares listed on regulated markets.[35] Despite being a

---

[31] *See* Hanne S. Birkmose, *From Shareholder Rights to Shareholder Duties – A Transformation of EU Corporate Governance in a Sustainable Direction?*, 5 INTEREULAWEAST 69, 72 (2018).

[32] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, 2017 O.J. (L 184), art. 3g, as amended by SHRD II.

[33] For a positive evaluation of the potential impact of the SHRD II on investor engagement with respect to ESG factors, *see* Giovanni Strampelli, *Are Passive Index Funds Active Owners: Corporate Governance Consequences of Passive Investing*, 55 SAN DIEGO L. REV. 803, 832-35 (2018). It is worth noting that the transposition of the SHRD II by the EU Member States should have been completed by 10 June 2019 (*see* SHRD II, art. 2). The assessment of its effects will need a more extended period of time even for a preliminary assessment.

[34] Specifically, according to the SHRD II transparency requirements on engagement strategies should apply to asset managers providing portfolio management services to investors (Directive 2014/65/EU, art. 4(1), point (1)), alternative investment fund managers (AIFM) (Directive 2011/61/EC, art. 4(1)(b), point (b)) when not exempted (Directive 2011/61/EC, art. 3), authorized management companies (Directive 2009/65/EC, art. 2(1), point (b)), and investment companies still authorized in accordance to the last mentioned Directive that have not designated a management company for their management.

[35] *See, e.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 874-76, 886, 916 (2013); John D. Morley, *Too Big to Be Activist*, 92 S. CAL. L.

Electronic copy available at: https://ssrn.com/abstract=3536460

heterogeneous category (including, for example, both passive and active investors and investors with differing investment horizons), they hold a significant amount of equity worldwide, as opposed to the marginal portion of equity directly held by physical or retail investors. Accordingly, it is institutional investor engagement with respect to ESG factors that promises the greatest results, even if the rest of the investor community does not (immediately) follow suit. Indeed, empirical research has shown that institutional investors are a driving force behind environmental and social performance. They often engage through private channels (on an on-going basis and frequently outside the general meeting) pushing companies for stronger performance in environmental and social matters.[36]

Second, since institutional investors own highly diversified portfolios, externalities caused by one firm may impact, even significantly, the profitability of other investee companies, and thus the overall performance of the institutional investor's portfolio. The magnitude of these effects increases with the level of diversification of the portfolio, reaching its maximum for the so-called "universal owners", i.e. investors whose portfolio represents the entire economy.[37] From the point of view of these investors, real incentives exist to force investee companies to offer more accurate reporting on the social and environmental costs caused or incurred by them, as well as on the related risk assessments, because harms caused by one investee firm could determine increased costs for another. On the basis of this, institutional investors may thus exert pressure on investee firms to reduce negative externalities and internalize costs or to undertake actions that produce positive impacts on the environment and society. Significantly, this often coincides with the interests of the institutional investors' final beneficiaries, irrespectively of what their individual preferences are about sustainability issues.

In other words, institutional investors represent an investor group that can exercise significant pressure on issuers, and it might be in their interest to go beyond a short-term and atomistic view of the business to place ESG factors within their engagement strategies. From the perspective of these shareholders, it could be perfectly reasonable to devote resources to the betterment of society and the environment, so long as this strategy turns out to benefit the company's profitability as well.

REV. 1407, 1409-10, 1425 (2019); Paolo Santella, Enrico Baffi, Carlo Drago & Dino Lattuca, *Legal Obstacles to Institutional Investor Activism in the EU and in the US*, 23 EUR. BUS. L. REV. 257, 260-62, 272 (2012).

[36] Alexander Dyck, Karl V. Lins, Lukas Roth & Hannes F. Wagner, *Do institutional investors drive corporate social responsibility? International evidence*, 131 J. FIN. ECON. 693, 702-03 (2019). *See* Fisch & Sepe, *supra* note 8, at 25.

[37] Harper Ho, *supra* note 15, at 84-85.

Electronic copy available at: https://ssrn.com/abstract=3536460

The third argument that supports a positive assessment of the approach taken by the SHRD II relates to institutional investors' reputation. Attention to ESG factors brings social rewards and avoids social sanctions. In becoming advocates for the sustainability demands of their final beneficiaries, institutional investors may use the threat of exit and commit to invest only in firms with specific ESG policies, influencing their investee companies' choices and cost of capital.[38] When they do so, they project the image of a socially and environmentally cautious market player, with all the resulting reputational advantages.

In conclusion, the foreseeable positive impact of the SHRD II concerns its role in facilitating investor coordination and collective action. By putting ESG factors into the agenda of all institutional investors, the SHRD II urges even investors with small block-holdings or index funds to wind their traditional apathy and engage with investee companies. Social goals underpinning engagement on ESG factors may provide fertile ground for cooperation more than competition, while investors seek to obtain from their portfolio companies the relevant information needed for engaging. [39]

3. *The MiFID II: How to Integrate ESG Considerations into Investment Processes*

Institutional investor engagement on ESG factors is far from embodying a pure stakeholder-oriented approach, or a genuine and disinterested effort to benefit society. Rather, it reflects the way in which complex asset portfolios are managed. Institutional investors have pure economic incentives to understand and take into account, in their investment strategies, how negative externalities caused by one investee company negatively affect other investee companies or, conversely, whether sustainability or remediation strategies undertaken by one company have a long-term impact on performance or produce positive externalities for other companies in the portfolio. We are not assuming that institutional investors are never influenced by a sincere attention to society and the environment (possibly and hopefully they are), but a compelling reason to be optimistic about the results of institutional investor engagement in sustainability issues is that moving away from the "atomistic" short-term results of the single investee company might actually be profitable for the overall portfolio. In this context, the achievement of sustainable results and consideration of the

[38] *Cf.* Dyck, Lins, Roth & Wagner, *supra* note 36, at 702.

[39] *Cf.* Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, 2019 U. ILL. L. REV. 223. With respect to the mechanisms that could facilitate institutional investor collective engagement, *cf. also* Balp & Strampelli, *supra* note 8.

Electronic copy available at: https://ssrn.com/abstract=3536460

overall risks related to ESG matters are going to gain increasing importance in the balancing of the institutional investors' portfolio.

A different question concerns whether non-institutional investors (both professional and retail clients, according to the MiFID II classifications) will spontaneously consider ESG factors in their investment choices due to a sincere attention to social and environmental issues or will need a "nudge" in that direction instead. Significantly, it is usually the financial intermediaries that convey other investors' preferences into investment decisions, because of their essential role in the investment process. As a result, financial intermediaries can contribute to stir the preferences of their clients towards sustainable investments, signaling investment opportunities that their clients might not have considered of their own accord. Indeed, "by providing advice, investment firms and insurance distributors can play a central role in reorienting the financial system towards sustainability".[40]

In this respect, several legislative proposals are currently under discussion in Europe within the framework of the Action Plan and the MiFID II.[41] The Action Plan envisages the inclusion of ESG factors in the suitability assessment of client preferences that financial intermediaries must conduct pursuant to the MiFID II. This could mean that in order to satisfy the suitability requirement set forth by the MiFID II[42]—which is traditionally aimed at tailoring investment advisory and portfolio management services on the client's knowledge and investment experience, ability to bear losses, investments objectives, and risk tolerance—information about the client's

---

[40] Action Plan, *supra* note 4, at 6; Timo Bush, Rob Bauer & Marc Orlitzky, *Sustainable Development and Financial Markets: Old paths and New Avenues*, 55 BUS. & SOC'Y 303, 311 (2016).

[41] *See* the *Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment*, COM(2018) 353 final (May 24, 2018), and also the two other proposals that have not been endorsed yet by the European Commission: *Commission Delegated Regulation (EU) …/… of XXX amending Delegated Regulation (EU) 2017/565 as regards the integration of Environmental, Social and Governance (ESG) considerations and preferences into the investment advice and portfolio management*, https://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-act-2018_en.pdf; *Commission Delegated Regulation (EU) …/… of XXX amending Delegated Regulation (EU) 2017/565 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organizational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive*, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=pi_com%3AAres%282018%292681500. *See also* ESMA, *Final report. Esma's technical advice to the European Commission on integrating sustainability risks and factors in MiFID II*, ESMA35-43-1737 (Apr. 30, 2019).

[42] MiFID II, art. 25, para 2, and Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organizational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive, 2017 O.J. (L 87) [hereinafter "Delegated Regulation 2017/565"], art. 54.

Electronic copy available at: https://ssrn.com/abstract=3536460

non-financial goals, such as ESG preferences, would also be gathered by the financial intermediary. The inclusion of non-financial preferences in individual profiles through a questionnaire filled in by the client has been currently proposed by ESMA as "a good practice for firms",[43] even though Delegated Regulation 2017/565 has not been amended to mandate it yet.

The inclusion of ESG factors within the "know your costumer" exercise that financial intermediaries should undertake before providing investment services to their clients is, hence, a subtle mechanism that should favor sustainable investments. Despite the apparent neutrality of the questions regarding the investor's attention towards ESG aspects, their very inclusion in the questionnaire underscores that investor preferences can and do affect the real economy and may lead to concrete corporate actions towards sustainability.

Behavioral finance will tell us if questions directly addressed to investors about their commitment to ESG factors are enough to induce them to make sustainable investment choices. For the time being, we should be mindful of a potential negative side-effect of this solution. Financial intermediaries, who must act according to client preferences, in considering their client's ESG preferences could underestimate the more traditional information regarding the client's financial objectives, risk tolerance, knowledge and experience in the investment field, and thus recommend or make on behalf the client unsuitable investments. A possible solution consists in ranking the client's financial and non-financial preferences, eventually placing ESG considerations in a secondary position. Accordingly, depending on the investor profile and relevant circumstances, ESG factors could be considered only after giving weight to the more risk-related features of the investment.

It is, however, still early to draw conclusions on the various proposals that flow from the Action Plan. The only sure thing is that the regulatory system under construction aims at redirecting the demand side of the market towards sustainability, hoping that investors will prompt investment firms and banks to urgently consider ESG factors in their investment decisions, ultimately decreasing the cost of capital for more socially responsible and sustainable issuers.

4. *The Role of Non-Financial Disclosure: Enhancing Shareholder Monitoring*

[43] ESMA, *Final Report. Guidelines on certain aspects of the MiFID II suitability requirement*s, at 38, ESMA35-43-869 (May 28, 2018).

Electronic copy available at: https://ssrn.com/abstract=3536460

As it has now become apparent, non-financial disclosure occupies a prominent place among the tools that the European lawmaker has employed to foster sustainability. Disclosure on institutional investors' engagement policies should encourage them to pay more attention to ESG factors. Moreover, if the current reform proposals became law, financial intermediaries would increasingly take sustainability issues into account in giving financial advice and managing portfolios. These two results would not be possible without the availability of non-financial information. To be sure, institutional investors and financial intermediaries could still request and obtain from investee companies relevant sustainability data even absent a mandatory regime of non-financial reporting. However, non-financial reporting makes the company's social and environmental commitment more easily detectable and understandable, and thus facilitates shareholder voice and monitoring on sustainability issues through investment decisions, exit strategies, and direct engagement with the investee companies' executives and directors.[44]

Interestingly, non-financial disclosure is an attractive regulatory tool irrespective of the view that one adopts regarding corporate purpose.[45] Because it does not constrain corporate action, it is equally appealing to those who believe that the purpose of a corporation should be to maximize shareholder value, putting shareholder interests first,[46] and to those who claim that corporate directors should also take into account the interests of different constituencies, in an effort to mediate among them.[47] These two

---

[44] *See, e.g.*, Waygood, *supra* note 24, at 83-85; Hank Boerner, *Sustainable and Responsible Investment: The Revolution Is On*, CORP. FIN. REV., May/June 2010, at 39, 40.

[45] *See generally* David Hess, *The Transparency Trap: Non-Financial Disclosure and the Responsibility of Business to Respect Human Rights*, 56 AM. BUS. L. J. 5, 7 (2019) (observing that "disclosure laws are typically appealing to all legislators regardless of where they may fall on the political spectrum").

[46] In the United States, the opinion that corporate directors should exercise their power in the interest of the shareholders is generally traced back to a famous article by Adolf Berle Jr. *See* Adolf A. Berle Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931). More recently, on shareholder primacy and the shareholder value maximization norm, *see, e.g.,* Milton Friedman, *The Social Responsibility of Business Is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine), at 32; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 35-39 (1991); Jonathan R. Macey & Geoffrey P. Miller, *Corporate Stakeholders: A Contractual Perspective*, 43 U. TORONTO L. J. 401 (1993). To be sure, the shareholder primacy norm does not necessarily coincide with maximizing shareholder value, but simply requires that shareholders be preferred to other corporate constituencies when balancing different corporate interests. As a matter of fact, however, putting shareholders' interests first usually implies maximizing shareholder value.

[47] *See* E. Merrick Dodd Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932) (arguing, in response to Adolf Berle Jr.'s 1931 article, that managers should also consider the interests of non-shareholder constituencies). More recently, *see* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); STOUT, *supra* note 9.

Electronic copy available at: https://ssrn.com/abstract=3536460

views have opposed one another for decades.[48] They seem to agree, however, on non-financial disclosure. While for the supporters of the first non-financial disclosure is a tool to stress the social and environmental commitment of the corporation, without constraining it to actions that might sacrifice profits; for the proponents of the second, it enables the company to show how its multi-stakeholder approach has been implemented in practice.

One should, however, not make the mistake of thinking that the current European regulatory framework is agnostic on the subject. As a matter of fact, the aforementioned legal strategies take a stance, albeit indirectly, in favor of shareholder primacy. Indeed, we argue that instead of shifting the focus of corporate governance from shareholders to stakeholders, the European lawmaker continues to rely on shareholder monitoring and engagement even for sustainability goals, and that this is actually a commendable choice.[49] The problem with the stakeholder approach is, as known, accountability. If corporations ought to be mindful of all stakeholders' concerns (and ideally report on matters that may be of interest for different stakeholder groups), there is no single benchmark against which to evaluate corporate action. Having too many masters means accountability to none.[50] This is why current corporate governance systems continue to rely on shareholders—and shareholders only—to monitor and influence managerial action through voting and exit decisions. This is also why, at the European level, the key route to foster long-termism and sustainability still goes through current shareholder-centered accountability mechanisms.

The persistent reliance of the European legal system on shareholder engagement and monitoring implies that non-financial disclosure should focus on at least two sets of issues: (*i*) sustainability policies and governance choices that might positively impact firm performance in the future, as well as the principal risks created by company operations and how the company manages them;[51] (*ii*) (exogenous) social and environmental factors that might have a positive or negative effect on the company's long-term

---

[48] *See, e.g.*, Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 646-50 (2006); David Rönnegard & N. Craig Smith, *Shareholder Primacy vs. Stakeholder Theory: The Law as Constraint and Potential Enabler of Stakeholder Concerns* 1-4 (INSEAD Working Paper No. 2018/15/ATL/Social Innovation Centre), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3165992.

[49] *See* Birkmose, *supra* note 31, at 72-78 (noting that shareholders have been the center of attention of the EU legislation). *See also* Hess, *supra* note 45, at 44-45, 51 (arguing that non-financial disclosure on human rights should target shareholders).

[50] EASTERBROOK & FISCHEL, *supra* note 46, at 38 (maintaining that "a manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither").

[51] *See* Directive 2013/34/EU arts. 19a, para. 1, lett. d), and 29a, para. 1, lett. d), as amended by the Non-Financial Disclosure Directive.

Electronic copy available at: https://ssrn.com/abstract=3536460

profitability, representing potential opportunities or challenges for the firm. Examples of the first are the efficiencies obtained by a more responsible use of (natural) resources, such as water, electricity, or paper, or the development of a new technique to manage the company's polluting waste. These improvements may lead to cost savings, efficiencies in the production processes, reputational benefits, and/or to greater demand from environmentally cautious customers, and thus may have, depending on the circumstances, a positive effect on the company's financials in a long-term perspective. Examples of the second are the challenges and opportunities created by ungovernable risks of the business, including conditions such as climate change, global warming, population aging, and so forth. A warmer planet could mean at the same time greater revenues for producers of air conditioners and less profits for skiing resorts.[52] The disclosure should, however, not be limited to the impact of these ungovernable risks on company operations. Significantly, how firms cope with them is also important. Markets may, for instance, reward companies that invest in the discovery of new sustainable raw materials to deal with the prospective scarcity of current natural resources. All these circumstances are relevant for investors' decisions and should therefore be covered by the disclosure. Non-financial disclosure should, more generally, concern the impact on the company's business of ESG factors that the company might not control but that still affect its operations. This is because shareholder interests remain the fundamental benchmark against which non-financial disclosure should be assessed, even though in a new socially and environmentally responsible dimension. The disclosure should hence essentially cover what socially and environmentally responsible investors are or might be interested in.[53] The materiality principle, in turn, helps define what that is.

III. MATERIALITY IN NON-FINANCIAL DISCLOSURE

[52] *See* the Guidelines, *supra* note 25, at para. 3.4 (specifying that, where appropriate, the disclosure may address "science-based climate change scenarios"). *Cf.* Chiara Picciau & Emanuele Rimini, *Empowering Corporate Constituencies in the European Union: The Limits and Challenges of Non-Financial Disclosure*, *in* I LEGAL SCIENCE: FUNCTIONS, SIGNIFICANCE AND FUTURE IN LEGAL SYSTEMS 55, 66 (2019) (discussing the Guidelines and providing other examples).

[53] Even assuming that the disclosure should address all stakeholders, it is doubtful that non-investor constituencies, especially if unsophisticated, actually read and understand "management reports and 'semi-financial' statements". One could, in fact, argue that different groups of stakeholders are more easily reached through different communication means; and this seems confirmed by the fact that some companies have voluntarily adopted various types of non-financial disclosure depending on the intended audience. Picciau & Rimini, *supra* note 52, at 65. As a result, the European non-financial disclosure system, as is currently conceived, seems in any case better suited to meet investors' needs than the interests of the stakeholders.

Electronic copy available at: https://ssrn.com/abstract=3536460

The concept of materiality is ubiquitous in the regulation of disclosure obligations, being employed to determine which pieces of information should be made public among a wider set of available data.[54] Especially for large corporate organizations, the available information is often extensive. Assuming it to be possible (or desirable) to provide shareholders, the market and other interested parties with all available information, such a colossal disclosure would hardly benefit anyone. Information overloads make it very difficult to identify meaningful and important knowledge. Despite disclosure should theoretically lead to more efficient market prices, information overloads, coupled with investors' limited ability to examine, understand, and process information, might actually hamper transparency.[55] Materiality tries to solve the problem by singling out which data the recipients of the information should be concerned about and use in their decisions.

1. The Origins of the Concept: Materiality in Accounting and Auditing

The origins of the concept have to be traced back to accounting and auditing,[56] where materiality identifies important information to be included and verified in financial statements. To be sure, accounting rules typically specify, in some detail, which information should be reported in the company's financial statements and how. However, together with the "substance over form" principle, materiality provides a flexible criterion that allows some deviations from these predefined rules, which are justified by the need to ensure a fair and truthful representation of the financial and economic condition of the reporting company.[57]

Materiality may, for instance, discriminate between information that is important enough to be registered separately or that warrants additional

---

[54] *See generally* Shane Heitzman, Charles Wasley & Jerold Zimmerman, *The joint effects of materiality thresholds and voluntary disclosure incentives on firms' disclosure decisions*, 49 J. ACCT. & ECON. 109 (2010) (discussing the relation between voluntary disclosure and materiality: Provided that material information generally entails an obligation to disclose, only when information is immaterial the disclosure can be considered truly voluntary); Kin Lo, *Materiality and voluntary disclosure*, 49 J. ACCT. & ECON. 133 (2010) (reviewing the previously cited study by Heitzman, Wasley and Zimmerman).

[55] Leopold A. Bernstein, *The Concept of Materiality*, 42 ACCT. REV. 86, 87-88 (1967).

[56] *See* Carla Edgley, *A genealogy of accounting materiality*, 25 CRITICAL PERSP. ON ACCT. 255, 257 (2013) (on the historical origins of materiality). On materiality in accounting and auditing, *see generally* Bernstein, *supra* note 55; Paul Frishkoff, *An Empirical Investigation of the Concept of Materiality in Accounting*, 8 J. ACCT. RES. 116 (1970); Mayya Gordeeva, *Materiality in Accounting*, 15 ECON. & MGMT. 41 (2011).

[57] *Cf.* Edgley, *supra* note 56, at 257 (observing that "companies are required to disclose a true and fair view in law but this is subject to uncertainty. Materiality allows for a degree of flexibility").

Electronic copy available at: https://ssrn.com/abstract=3536460

explanation from information that may be reported in the aggregate or may not be reported at all.[58] Materiality may also help determine whether information about future events or facts, such as future expenses or the materialization of a given risk, is probable, significant or precise enough to be accounted for. However, the applicable accounting standards may allow companies to avoid immediate recognition even of sufficiently probable and precise information regarding future outflows, provided that they do not consist in present obligations, thus encouraging a short-term focus.[59] In sum, materiality is a selection criterion that helps producers and users of financial statements concentrate on what is, or should be, most important to them, within the timeframe of the reporting period and thus generally in a short-term perspective.

In auditing, the notion of materiality contributes to the assessment of the accuracy of the financial statements. It is often said that auditors should only be concerned about material mistakes, misstatements or omissions, since only these impair the true and fair representation of the company's situation.[60]

Significantly, the definitions of "materiality" adopted in the United States by the Financial Accounting Standards Board (FASB) and at the international level by the International Accounting Standards Board (IASB),[61] take both these aspects into consideration. According to the FASB,

---

[58] *See* Bernstein, *supra* note 55, at 88 (according to whom "to make the information not misleading, items which do not matter need no separate disclosure"). *See also* Gordeeva, *supra* note 56, at 43.

[59] The accounting treatment of "provisions" under the International Accounting Standard (IAS) 37, adopted in the European Union by Commission Regulation (EC) No. 1126/2008, 2008 O.J. (L 320) 1, is an important example in this respect. Provisions are liabilities of uncertain timing or amount that must be recognized only when three conditions are met: (*i*) the entity has a present obligation; (*ii*) it is probable that the settlement of the obligation will result in an outflow of resources; and (*iii*) a reliable estimate of the amount involved can be done (*see* IAS 37, para. 14). Accordingly, even when there is sufficient probability of an outflow whose amount can be reliably estimated, if the obligation which the outflow refers to is not present, no recognition of a provision must be made in the entity's financial statements. This is because, according to IAS 37, para. 18, "[f]inancial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's balance sheet are those that exist at the balance sheet date".

[60] *See, e.g.*, Andrew A. Acito, Jeffrey J. Burks & W. Bruce Johnson, *Materiality Decisions and the Correction of Accounting Errors*, 84 ACCT. REV. 659, 660, 662 (2009) (pointing out that according to the US GAAP immaterial accounting errors do not lead to formal restatements of the company's accounts).

[61] The IASB issues the IAS/IFRS accounting principles, which have been endorsed within the European Union for certain reporting companies. *See* Regulation (EC) No. 1606/2002

Electronic copy available at: https://ssrn.com/abstract=3536460

> [t]he omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.[62]

Similarly, the IASB has recently specified that

> [i]nformation is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.[63]

For both definitions, materiality is the result of a professional judgment made by management first and by auditors later,[64] who cannot possibly verify every single entry and should not bother with (inaccurate) data that do not really matter.[65] However, it is also a tool to protect the decision-making process of the users of the financial statements.[66]

2. Financial Markets Regulation and Materiality

The definitions of materiality used in financial markets regulation generally overlap to a large extent with the accounting notion. Although terminological differences may persist, the two concepts are typically very similar.[67] This is particularly evident in the United States, where the FASB recently amended the accounting definition of materiality in order to ensure

---

of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, 2002 O.J. (L 243) 1.

[62] FASB, *Chapter 3 – Qualitative Characteristics of Useful Financial Information*, *in* CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING QC11 (2018), https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176171111398&acceptedDisclaimer=true.

[63] IASB, *IASB clarifies its definition of 'material'*, IFRS (Oct. 31, 2018), https://www.ifrs.org/news-and-events/2018/10/iasb-clarifies-its-definition-of-material.

[64] Edgley, *supra* note 56, at 257.

[65] Bernstein, *supra* note 55, at 88; Edgley, *supra* note 56, at 262-64 (according to whom some conceptions of materiality stress the fact that it operates as a cost/benefit solution for auditors, who should not worry about trivial mistakes and omissions, and that materiality judgments are the result of expert, scientific knowledge).

[66] Edgley, *supra* note 56, at 260-62 (observing that, in some conceptions, "materiality has been objectivised as a moral responsibility to protect investors" and their wealth "from the damaging consequences of misleading information").

[67] *Cf. id.* at 262 (noting that "accounting and legal definitions [of materiality] have not fully converged").

Electronic copy available at: https://ssrn.com/abstract=3536460

consistency with the one adopted by the Securities and Exchange Commission (SEC) and the US case law, among others.[68]

In financial markets regulation, materiality continues to identify an ideal threshold that signals which information is sufficiently useful for its recipients and should thus be disclosed, as well as which inaccuracies, mistakes or omissions are important enough to warrant reaction from the legal system, usually in the form of liability for misrepresentation. Two other defining elements, however, emerge.

One of them is the relevance of the price effect of the information for the materiality assessment, which is taken into account both in the United States and in the European Union, albeit in different capacities. In the United States, absent continuous disclosure obligations, the notion of materiality is invoked in disparate contexts and for a variety of periodic and episodic disclosures.[69] For instance, Regulation Fair Disclosure provides that an issuer must publicly disclose all material non-public information regarding the issuer itself or its securities that has been selectively disclosed by the issuer or a person acting on its behalf to certain specified recipients.[70] Within the existing disclosure obligations, the SEC Staff Accounting Bulletin no. 99 identifies qualitative criteria to be used along with a quantitative threshold to determine the materiality of the content of the information. These criteria significantly include factors—such as "whether the misstatement masks a change in earnings or other trends", "hides a failure to meet analysts' consensus expectation for the enterprise", or "changes a loss into income or vice versa"[71]—that typically imply a price impact on the issuer's securities.[72] More generally, although it "ordinarily is not a principal inquiry under the U.S. securities laws when assessing

[68] FASB, *FASB Improves the Effectiveness of Disclosures in Notes to Financial Statements* (Aug. 28, 2018), https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176171117438&d=&pagename=FASB%2FFASBContent_C%2FNewsPage.

[69] Materiality considerations are relevant, for example, in the context of proxy solicitations, proxy statements, selective disclosure, periodic reporting, public offerings, and with respect to the statements made in registration statements and prospectuses.

[70] 17 C.F.R. § 243.100 (2019).

[71] SEC, *Staff Accounting Bulletin No. 99 – Materiality* (Aug. 12, 1999), https://www.sec.gov/interps/account/sab99.htm.

[72] It has to be stressed, however, that an information can be material even if it does not have any price impact. This is because, technically, "the 'reasonable' investor need not be the marginal investor (i.e., the investor who causes the price to change)". Accordingly, "an item can still be material even if its disclosure does not cause a change in the value of the debt or equity security". Heitzman, Wasley & Zimmerman, *supra* note 54, at 113.

Electronic copy available at: https://ssrn.com/abstract=3536460

materiality of the alleged disclosure deficiency", price impact is still a key issue in US securities litigation.[73]

Within the European Union materiality comes into play in the context of issuers' continuous disclosure obligations set forth by Article 17 of the European Market Abuse Regulation.[74] To be sure, the Regulation does not mention the concept of materiality, but implicitly refers to it by employing the price impact as the fundamental criterion to determine whether a piece of information is sufficiently relevant (*rectius*, material) to be disclosed.[75] The disclosure obligations cover, in fact, precise non-public information which, if made public, would have a significant effect on the price of the issuer's securities or related derivatives (a trait commonly known as the "price sensitivity" of the information).[76]

The other defining feature of materiality in financial markets regulation, which can be found both in the United States and in the European Union, is the more precise identification of the recipient or user of the information. While accounting definitions of materiality often generically refer to "users" of financial statements or to "investors", being financial statements' primary users,[77] sometimes qualifying them as "informed"[78] or with other attributes, US and EU financial markets laws have more consistently invoked the

---

[73] Marc I. Steinberg, *Texas Gulf Sulphur at Fifty – A Contemporary and Historical Perspective*, 71 SMU L. REV. 625, 630 (2018). *Cf.* Richard A. Booth, *The Two Faces of Materiality*, 38 DEL. J. CORP. L. 517 (2013).

[74] Regulation (EU) No. 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, 2014 O.J. (L 173) 1 [hereinafter the "Market Abuse Regulation" or "MAR"].

[75] Marco Ventoruzzo & Chiara Picciau, *Article 7: Inside Information*, *in* MARKET ABUSE REGULATION. COMMENTARY AND ANNOTATED GUIDE 175, 200-01 (Marco Ventoruzzo & Sebastian Mock eds., 2017) (discussing the notion of price sensitivity and contending that, even though the European Market Abuse Regulation does not refer to the concept of materiality, the notion of price sensitivity is employed in a similar sense).

[76] MAR art. 7, para. 1, lett. a).

[77] *See* Marco Fasan & Chiara Mio, *Fostering Stakeholder Engagement: The Role of Materiality Disclosure in Integrated Reporting*, 26 BUS. STRATEGY & THE ENV'T 288, 290 (2017) (observing that "both the FASB and the IASB have a user approach to materiality"). *See also* the definition of materiality adopted by the IASB, which makes reference to financial statements' "primary users" without explicitly identifying them: *supra*, paragraph 2, Part III, and accompanying notes. Significantly, shareholders and investors are not the only users of financial statements. Moreover, within the investor group, one could differentiate between sophisticated and retail investors. Both categories have different information needs, capabilities and interests. *See* Strampelli, *supra* note 7, at 547-52.

[78] AMERICAN ACCOUNTING ASSOCIATION, ACCOUNTING AND REPORTING STANDARDS FOR CORPORATE FINANCIAL STATEMENTS AND PRECEDING STATEMENTS AND SUPPLEMENTS 8 (1957), also cited by Bernstein, *supra* note 55, at 94.

Electronic copy available at: https://ssrn.com/abstract=3536460

figure of the “reasonable” investor or shareholder.[79] According to the US Supreme Court, information is material “if there is a substantial likelihood that a reasonable shareholder would consider it important” in his or her decisions. Namely, “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available”.[80] The European Market Abuse Regulation adopts a comparable approach, but goes even further by linking the price sensitivity of the information to the expectations of the reasonable investor. In that context, price-sensitive information means “information that a reasonable investor would be likely to use as part of the basis of his or her investment decisions”.[81]

The combined effect of these two factors is that, in both US and EU financial markets regulation, the reasonable investor becomes the benchmark against which to assess what should be disclosed and what can remain private. If a reasonable investor would consider the information important to make (investment or voting) decisions, the information is material and should be disclosed. An important criterion to determine whether a reasonable investor would consider the information important is, in turn, its price sensitivity. In fact, despite putting an emphasis on the price impact of the information might contribute to foster short-termism, the law generally presumes that price-sensitive information is relevant for investors’ decisions and that relevant information for investors does affect prices.

Materiality hence emerges as a relational and contextual notion. Something is material for a given user in order to make a given decision, considering the context and all other relevant circumstances. Among these, particular attention is given to the size of the firm,[82] the industry or sector to which it belongs,[83] and so forth,[84] provided that what is material for a company of a given size or industry might not be material for companies of a non-

---

[79] *See generally* Amanda M. Rose, *The “Reasonable Investor” of Federal Securities Law: Insights from Tort Law’s “Reasonable Person” and Suggested Reform*s, 43 J. CORP. L. 77, 86-102 (2017) (discussing the reasonable investor criterion in US securities law); Ventoruzzo & Picciau, *supra* note 75, at 200-03.

[80] TSC Industries, Inc. v. Northway, 426 U.S. 438, 449 (1976) (with respect to information that is deemed material for voting decisions). *See* Basic Inc. v. Levinson, 485 U.S. 224 (1998) (regarding materiality for investment decisions).

[81] MAR art. 7, para. 4.

[82] *See* Heitzman, Wasley & Zimmerman, *supra* note 54, at 128.

[83] *See* Khan, Serafeim & Yoon, *supra* note 27, at 1697, 1699-1700 (observing that “the materiality of the different sustainability issues likely varies systematically across firms and industries”).

[84] Interestingly, materiality assessments might also be influenced by previous materiality decisions of other firms. *See* Acito, Burks & Johnson, *supra* note 60, *passim* (discussing the factors that influence decisions on the materiality of accounting errors leading to a restatement of the company’s financial reports).

Electronic copy available at: https://ssrn.com/abstract=3536460

comparable size or industry. In purely abstract terms, however, the main determinant of the materiality concept is the *objective* of the disclosure. If materiality is used, as in financial markets regulation, to define the content of financial disclosure for the benefit of the reasonable investor, certain elements that are of interest to this investor, such as the price sensitiveness of the information, become utterly relevant.

3. Non-Financial Disclosure and Materiality

Materiality has recently entered the realm of non-financial disclosure. The Global Reporting Initiative (GRI), a non-profit organization that issues international standards for sustainability reporting (the so-called "GRI Standards"), included materiality as one of the foundation principles of sustainability reporting.[85] In the United States, the Sustainability Accounting Standards Board (SASB), which sets standards for sustainability accounting, indicates materiality as one of the main objectives of the disclosure,[86] while the International Federation of Accountants (IFAC) considers materiality a crucial concept of integrated financial and non-financial reporting.[87] Even the European Commission's Guidelines on non-financial disclosure,[88] which were adopted in compliance with Directive 2014/95/EU,[89] mention materiality as one of the key principles of non-financial reporting.[90]

At a closer look, however, in the context of non-financial disclosure materiality is invoked in two slightly different connotations. For instance, the GRI Standards embrace a multi-stakeholder approach, whereby the materiality threshold is defined by taking into account a wider range of impacts than those traditionally covered by financial disclosure, as well as all relevant stakeholders.[91] According to this approach, all stakeholders

---

[85] GRI, GRI 101: FOUNDATION 10-11 (2016), https://www.globalreporting.org/standards/gri-standards-download-center/gri-101-foundation-containing-standard-interpretation-1.

[86] SASB, SASB CONCEPTUAL FRAMEWORK 9 (Feb. 2017), https://www.sasb.org/wp-content/uploads/2019/05/SASB-Conceptual-Framework.pdf.

[87] IFAC, MATERIALITY IN <IR>. GUIDANCE FOR THE PREPARATION OF INTEGRATED REPORTS (Nov. 2015), https://integratedreporting.org/wp-content/uploads/2015/11/1315_MaterialityinIR_Doc_4a_Interactive.pdf. *See*, also for references, Fasan & Mio, *supra* note 77, at 288-89 (providing a definition of integrated reporting).

[88] Guidelines, *supra* note 25.

[89] Directive 2014/95/EU art. 2.

[90] Guidelines, *supra* note 25, at para. 3.1.

[91] GRI, *supra* note 85, at 10. *Cf.* Khan, Serafeim & Yoon, *supra* note 27, at 1700-01 (comparing the focus of the materiality definition adopted by the SASB with the one of the GRI definition).

Electronic copy available at: https://ssrn.com/abstract=3536460

constitute the relevant benchmark to determine whether a piece of information is material, not only investors or shareholders. The disclosed information should thus be useful and important for the decisions of the stakeholders and should address their concerns, expectations and interests.[92]

By contrast, especially for integrated reporting, which combines in a single document financial and non-financial information to explain how (long-term) value is created,[93] the relevant benchmark is still the investor,[94] while stakeholder engagement is invoked to identify the areas on which the disclosure should focus. The information must be important for the decisions of actual or potential shareholders, even when it addresses non-financial issues that might be of interest to other constituencies as well.

This ambiguity leads to different conceptions of materiality in non-financial disclosure, which seemingly reflect the persistent struggle between the two opposing theories on corporate purpose that have been mentioned in Part II. Provided that disclosure serves as a way to stir company behavior, including all stakeholders in the materiality benchmark contributes to foster consideration of their position in business decisions. Conversely, referring to investors as the main recipients of the information continues to endorse a

---

[92] *Cf.* Fasan & Mio, *supra* note 77, at 290 (discussing materiality in the context of non-financial information); Sie Bing Ngu & Azlan Amran, *Materiality disclosure in sustainability reporting: fostering stakeholder engagement*, 34 STRATEGIC DIRECTION 1, 2 (2018).

[93] According to the International Integrated Reporting Council (IIRC), "an integrated report is a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term". IIRC, *What? The Tool for Better Reporting*, INTEGRATEDREPORTING.ORG, https://integratedreporting.org/what-the-tool-for-better-reporting (last visited Jan. 26, 2020). More generally, integrated reporting refers to a combination of financial and non-financial data that is aimed at shedding light on a company's strategies and value creation processes.

[94] *See* Fasan & Mio, *supra* note 77, at 291 (observing that the IIRC, the leading organization on integrated reporting, "specifies that the intended users of IR [integrated reporting] are the providers of financial capital, and the issues must be material to them"). The SASB also explicitly identifies investors as the recipients of sustainability information, specifying that its framework applies the same materiality standard already established under US securities laws. SASB, *supra* note 86, at 9. *See* Khan, Serafeim & Yoon, *supra* note 27, at 1698, 1700.

Electronic copy available at: https://ssrn.com/abstract=3536460

shareholder primacy view, albeit in a milder, more socially conscious version.[95]

The European Commission's Guidelines are a good example of this ambiguity.[96] On the one hand, they state that the purpose of the disclosure is to provide transparency to, and satisfy the information needs of, the relevant stakeholders,[97] expecting companies to engage with them in order to select which issues or topics should be covered by sustainability reports.[98] On the other hand, the new rules on non-financial disclosure are embedded in the already existing discipline of financial disclosure, as Directive 2014/95/EU amends Directive 2013/34/EU on annual financial statements, consolidated statements and related reports, which contains a "traditional" definition of materiality. The Guidelines themselves even make reference to the definition of materiality that is commonly employed for financial reporting (notably, the one adopted by Directive 2013/34/EU),[99] raising the question of whether we actually need a new understanding of materiality in non-financial disclosure. In particular, the question is whether materiality in non-financial disclosure entails only a minor adjustment to common notions of materiality, covering information that is likely to have a financial impact but that is not immediately captured by financial disclosure, or whether it also includes information on facts or events that may never have any financial impact, but that are of interest to a broader set of non-shareholder constituencies.

a. Do We Need a New Understanding of Materiality in Non-Financial Disclosure?

Solving this uncertainty bears important consequences for the content of non-financial reports, as different stakeholders are likely to have different views on which pieces of information are important for their decision-

[95] The theoretical framework for protecting the interests of such socially and environmentally conscious shareholders could be found in the so-called "enlightened shareholder value" approach. *See* Harper Ho, *supra* note 15, *passim*.

[96] *See* Picciau & Rimini, *supra note* 52, at 65-66.

[97] Guidelines, *supra* note 25, at paras. 2, 3.1 (where the Commission states that "[t]he non-financial statement is expected to reflect a company's fair view of the information needed by relevant stakeholders"), 3.3 (where it is said that " [a] company should focus on providing the breadth and depth of information that will help stakeholders understand its development, performance, position and the impact of its activities"), 3.4, and especially 3.5.

[98] *Id.* at paras. 3.1, 3.2, 3.5, and especially 4 (specifying that "[c]ompanies are expected to identify the specific thematic aspects and material information to be included in their disclosures in a fair, balanced and comprehensive manner, including by engaging with relevant stakeholders").

[99] *Id.* at para. 3.1 (referring to art. 2, para. 6, of Directive 2013/34/EU).

Electronic copy available at: https://ssrn.com/abstract=3536460

making processes.[100] Indeed, even those stakeholders that have largely homogenous financial interests, such as shareholders and creditors, might not be equally attentive to financial information, due to their different status as residual or fixed claimants of the firm.[101]

The European regulatory framework implies, however, that there are no workable alternatives to using investors as the relevant benchmark for materiality assessments, even in non-financial disclosure.[102] The main reason for this is, as anticipated, accountability. Corporate governance systems contemplate managerial accountability to shareholders only. Other stakeholders may and do put pressure on management, but are devoid of the rights and prerogatives that shape shareholders' corporate governance role. The legal strategies devised by the SHRD II and the MiFID II start from this premise and try to make institutional investors and financial intermediaries advocates for more sustainable corporate choices.[103] If these market players are to have any actual chance at playing this role, they need relevant non-financial information. It follows that the concept of materiality in non-financial disclosure must be tailored, first and foremost, to the information needs of the investor class.

Significantly, this does not require an entirely new materiality concept, but to give new meaning to existing categories and classifications. In particular, it calls for a new understanding of the notion of "investor",[104] who is not

---

[100] Fasan & Mio, *supra* note 77, at 290; Harper Ho, *supra* note 15, at 106.

[101] *See* Lo, *supra* note 54, at 133. *See also* Francesco Denozza, *Nonfinancial Disclosure Between 'Shareholder Value' and 'Socially Responsible Investing'*, *in* INVESTOR PROTECTION IN EUROPE: CORPORATE LAW MAKING. THE MIFID AND BEYOND 365, 370 (Guido Ferrarini & Eddy Wymeersch eds., 2006) (noting that "different groups of investors take into account – for their investment decisions – facts of a different nature"); Strampelli, *supra* note 7, at 557 (arguing that materiality assessments might be different even for different "types" of shareholders, such as retail and institutional investors, because of their different needs); Frishkoff, *supra* note 56, at 116-17. This point should, however, not be overstated since it can be expected that "there will be overlap between materiality classifications for different stakeholders". Khan, Serafeim & Yoon, *supra* note 27, at 1700.

[102] *Cf.* Esty & Karpilow, *supra* note 22, at 672-73 (also arguing in favor of a concept of materiality that "should be defined with the mainstream investor in mind—recognizing that many sustainability-minded investors want to get a line of sight on issues, such as climate change, that may not be financially material in the short term…but are likely to affect marketplace performance over time").

[103] *See supra*, para. 2, Part II, and the accompanying notes. *Cf.* Birkmose, *supra* note 31, at 78-92 (doubting, however, that the legal strategy employed by the SHRD II will actually reach the goal).

[104] The concepts and models that economic theory and legal rules employ have a significant effect on social and economic development. *See, e.g.*, Emilia Ferraro & Louise Reid, *On sustainability and materiality. Homo faber, a new approach*, 96 ECOLOGICAL ECON. 125 (2013) (arguing that recourse to cartesian epistemology and to the concept of *homo economicus* entails a precise view of the world that has fostered the unsustainability of contemporary society and that a shift to the concept of *homo faber*, which is not detached

Electronic copy available at: https://ssrn.com/abstract=3536460

simply "reasonable", but also socially and environmentally cautious, alert to ESG factors and possibly to the externalities that each portfolio company may cause to the business and operations of other investee companies. The relevant timeframe for the materiality assessment also extends to longer periods. The short-term focus of materiality in financial disclosure, derived from accounting rules and from the reference to price sensitivity, is explicitly discouraged by the new European regulatory framework on sustainable investments,[105] given that non-financial risks and opportunities often materialize over longer time spans and may not have, at least immediately, a price impact. Some evidence or consideration of the possible future financial impact of non-financial information is probably still needed, but the focus of the disclosure regime is on the long-term consequences of sustainability risks and opportunities, not on price sensitivity. As a result, price sensitivity will not serve anymore as the main criterion to determine what information is relevant for investors, and thus material, and what is not.

Materiality operates, in other words, as a general clause, whose meaning closely depends on the purpose of the disclosure in the specific case. When the purpose is sustainability, materiality is forward-looking, attentive to the long-term risks and opportunities connected to ESG factors and focused on the social and environmental impact of the company's operations.

b. What Role for the Stakeholders?

This does not mean that stakeholders are completely irrelevant in the new European regulatory framework. They play an important role in helping reporting companies identify the most critical areas that non-financial disclosure should address. The ambiguity of the European Commission's Guidelines on the relevant benchmark for the content of non-financial disclosure can, in fact, be solved considering that stakeholders usually are in the best position to signal where company operations had or may have their greatest impact.

The board of directors and its officers are entrusted by the Guidelines with the task of engaging with the different stakeholders—such as workers, consumers, interest groups, public authorities, local communities, and civil society more generally—in order to spot the issues that are "material" to the

---

from nature but rather engages with the corporeal and material dimensions of life, could help promote sustainability).

[105] *See* ESMA, *supra* note 41, at 4 (mentioning the goal of "foster[ing] transparency and long-termism in financial and economic activity").

Electronic copy available at: https://ssrn.com/abstract=3536460

specific company.[106] Here, materiality is used in a more objective fashion, almost as a synonym for "relevant", to indicate the non-financial matters that are strategically important for a particular firm operating in a given sector or industry.[107] There are, of course, similarities across sectors or industries. By way of example, while climate change issues, such as droughts and water shortages, are presumably more relevant for companies that provide irrigation services, worker safety concerns are typically more important for companies in labor-intensive industries. Each company has, however, its own specificities that largely depend on its core business and the communities with which it interacts. Real-life examples are not necessarily going to be as obvious as the ones provided above, and stakeholder engagement is a powerful tool to spot the risks and opportunities for the company that depend on non-financial factors,[108] helping managers to identify where sustainability policies and initiatives are most needed or suitable.

The reason is simple. Stakeholders are directly affected by company operations and are in the best position to pinpoint where and how the company is having or may have an impact. Consider, for instance, a manufacturing company discharging some of its liquid waste in a river. Local communities that get water from the river or fishermen are likely to be the first constituencies to notice the effects of water pollution and to bring it to the attention of company representatives. This, however, does not necessarily mean that the disclosure should have local communities and fishermen as its main recipients. These stakeholders may take advantage of it, benefit from the increased transparency, and put pressure on the company in case it does not take corrective action, but the intended recipient of the disclosure should still be the only corporate constituency entrusted with a monitoring role and powers: the shareholders.

Stakeholder engagement has, in any case, important implications on its own. The indirect relationship of mutual influence between stakeholder engagement and disclosure is well shown by what has been termed

[106] The Guidelines indicate that companies should perform materiality assessments at regular intervals and that the assessment should take into account both internal and external factors, including the company's business model, strategy and principal risks, the main sectoral issues, the interests and expectations of the relevant stakeholders, the impact of the company's activities, and other public policy and regulatory drivers (para 3.1). Even though the Guidelines do not explicitly identify which corporate body should be entrusted with this assessment, as it happens for financial disclosure, the assessment should fall under the responsibility of the board of directors and its designated officers.

[107] An example of materiality classification that, in abstract terms, identifies which issues or topics are likely to be material for a given sector or industry is provided, in the United States, by the SASB: *SASB Materiality Map*, SASB, http://materiality.sasb.org (last visited Jan. 26, 2020). *Cf.* Khan, Serafeim & Yoon, *supra* note 27, *passim*.

[108] *See* Ngu & Amran, *supra* note 92, at 2-3.

Electronic copy available at: https://ssrn.com/abstract=3536460

"materiality disclosure": i.e. the disclosure concerning how materiality assessments have been made by a specific company and how the different topics addressed in the sustainability report have been selected.[109] This disclosure may provide transparency on how non-shareholder constituencies have influenced materiality assessments in the particular case. Companies voluntarily provide this information in varying degrees depending on the industry or sector.[110] When they do, their reports often show that, regardless of who is the intended recipient of the non-financial disclosure, market pressure from different stakeholders influences the extent of materiality assessments.[111]

c. A Few Examples of Materiality Assessments in Action

A new understanding of the materiality concept in non-financial disclosure plays a greater role when sustainability initiatives have an uncertain impact on financials or are not otherwise captured by short-term-oriented financial disclosure. In these instances, taking the standpoint of the socially and environmentally cautious investor might broaden the extent of the disclosure as opposed to materiality assessments purely made for financial disclosure purposes. When the cost of making sustainable choices is immaterial, but their long-term effects are potentially huge, financial disclosure might not capture the information, while non-financial disclosure should.

One might argue that these are limited instances and that sustainability initiatives often have an immediate impact on financials or that they might be in any case material according to common definitions of materiality for financial reporting.[112] Consider, for instance, the case of a company that decides to open, within its premises, a nursery school for the employees' children. This initiative may entail significant expenditures, depending on whether the service is offered for free, at a discount or at full price, on the number of children that will attend the school on average, on the number of teachers that the company will hire, and so forth. These costs could be separately registered in the company's financial statements as cost items and/or assets. The company's choice may hence fall under at least one of the

[109] *See* Fasan & Mio, *supra* note 77, at 289.
[110] *Id.* at 291-92, 297-301.
[111] *Cf. id.* at 289, 300-03.
[112] Significantly, it has been argued that if a sufficient number of investors, which could well be below a 50% threshold of the total number of investors, base their investment decisions on non-financial information, this could have a price impact that would compel disclosure under the European market abuse rules, provided that the notion of price sensitivity is greatly dependent on investor demand. *See* Denozza, *supra* note 101, at 369-72.

Electronic copy available at: https://ssrn.com/abstract=3536460

different notions of materiality that are applicable in the realm of financial disclosure, namely the accounting notion, if not under other financial markets materiality standards. To be sure, many types of company information are covered by some form of disclosure. One can easily imagine, for example, that the launch of an innovative, less polluting battery by a car manufacturer will already be subject to general financial markets law disclosure obligations due to its potential price impact.

The reason to invoke a somewhat distinct notion of materiality for non-financial disclosure rests, however, on the fact that even in these cases financial disclosure might not reflect the full implications of the fact or event conveyed by the information.[113] Short-term costs might be easy to detect and to quantify, and the same might be true for market price effects, but this is not always the case for the long-term benefits that might ensue from sustainable or responsible corporate choices. How can greater employee loyalty, worker productivity, or company attractiveness for new talents be precisely accounted for and quantified? How can the company accurately predict and appraise the number of new customers that will be interested in buying a new car with a less polluting battery or that will boycott competitors that do not make similar environmentally responsible choices? Non-financial reports, through narrative disclosure,[114] provide the appropriate instrument to explain the foreseeable results of these policies apart from the figures, and offer an account of how sustainability practices can impact financial performance in the particular instance.

---

[113] *See* Esty & Karpilow, *supra* note 22, at 673 (cautioning against the adoption of narrow definitions of materiality, given that some sustainability issues may have long-term indirect effects on firm value); Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L. J. 923, 933-41 (2019) (contending that, in the United States, sustainability disclosure has historically been deemed not material by the SEC, but that this traditional opinion has shifted to some extent towards including some non-financial issues in financial disclosure); Harper Ho, *supra* note 15, at 81 (observing that non-financial issues, such as climate change, corporate governance, employment standards, environmental impacts and so forth, "are not typically reflected in standard accounting measures because they tend to be qualitative in nature and are related to externalities not well captured by" them).

[114] *See* Fisch, *supra* note 113, at 952-59 (proposing a narrative disclosure regime for sustainability issues). Narrative disclosure is particularly suited for non-financial disclosure, considering that most sustainability metrics that are quantitative in nature present significant shortcomings. *See* Hess, *supra* note 45, at 27-31. Narrative disclosure has been considered an important instrument to increase transparency also in the context of financial reporting. *See* Strampelli, *supra* note 7, *passim*. Consequence-oriented explanations of data have, after all, been found to have persuasive force. *See* F. Todd DeZoort, Dana R. Hermanson & Richard W. Houston, *Audit committee support for auditors: The effects of materiality justification and accounting precision*, 22 J. ACCT. & PUB. POL'Y 175 (2003) (showing that whether materiality is explained using both quantitative and consequence-oriented factors is, together with the precision of the accounting issue, one of the elements that might affect audit committees' propensity to support auditors' materiality determinations vis-à-vis the board of directors).

Electronic copy available at: https://ssrn.com/abstract=3536460

There are, of course, more tricky cases. Imagine, for example, that the CEO of a listed company openly takes a position in favor of a debated cause, such as paternal leaves or same-sex marriages. These statements entail no immediate cost for the company, but might affect its reputation and returns. Financial disclosure won't cover this information before it has any financial impact and, even when it does, the company's report might not clarify how the specific figure is affected by a qualitative determinant. Non-financial reports, which typically resort to narrative disclosure, could improve transparency. However, it is not entirely clear whether this information should be subject to non-financial disclosure at all. One might argue, for instance, that only when the CEO's statement amounts to an actual corporate strategy that might affect future returns the information should be made public; but again the answer depends on whether the relevant benchmark for the assessment are the investors or the stakeholders.

In the first case, disclosure must be given only if the statements are likely to have, even in the long-term, an impact on financials, for instance through reputation mechanisms, or if they were said according to a precise corporate strategy. In the second case, so long as the statements made might be of interest to customers, clients, other stakeholders, and even the public opinion, there is reason to support the disclosure. On a policy level the question then becomes whether the implications of this second interpretation, which results in greater disclosure, are desirable or may prove counterproductive for transparency. The European Union, through its shareholder-centric model of regulation, points in favor of the first.

IV. CONCLUSIONS

Non-financial disclosure helps solve two fundamental problems that hinder the adoption of sustainable corporate policies and strategies.[115] First, even when it pays to do good, companies might not behave well because the market does not reward responsible and sustainable conduct before it has an impact on the company's accounts. Second, at times it even pays to do bad, especially when financial statements and reports do not shed light on the negative externalities of company behavior.

These and other reasons support a mandatory regime of non-financial disclosure,[116] but the debate is still open on the extent and content of the information that the disclosure should include. This is partly due to

---

[115] Waygood, *supra* note 24, at 82-85.

[116] One of the most cited reasons to support mandatory disclosure is that, under voluntary disclosure regimes, companies tend to underreport negative information. *See* Esty & Karpilow, *supra* note 22, at 662-70; Fisch, *supra* note 113, at 947-48. *Cf.* Fasan & Mio, *supra* note 77, at 289.

Electronic copy available at: https://ssrn.com/abstract=3536460

ambiguities concerning how corporate directors should consider non-shareholder interests in their business choices and, more generally, to the long-standing debate on corporate purpose.[117] However, these ambiguities need not necessarily be resolved to appreciate the possible contribution of non-financial reporting.

Non-financial disclosure contributes to legitimize corporations in modern society by showing their collective commitment. Corporations developed and succeeded thanks to the benefit of limited liability and should return prosperity, social justice and economic growth to their constituencies.[118] To a certain extent, the disclosure makes this contribution more visible and is aimed at providing relevant information to stakeholders and society.

However, if the public goal is sustainable growth, lawmakers must devise strategies to "nudge" companies in the desired direction, and this means exploiting the corporate governance mechanism that makes corporate boards and managers accountable to shareholders only. The combined impact of the SHRD II, the MiFID II and the Non-Financial Disclosure Directive is that of enabling and inducing institutional investors and financial intermediaries to take ESG factors into account in order to make sustainable investment choices. A stronger regime of non-financial disclosure at the European level facilitates this result. A renewed understanding of the general materiality clause, shaped by the purpose and goals of the disclosure, then provides a key component of this strategy, giving relevance to the information needs of the rising socially and environmentally responsible investment movement. From this viewpoint, non-financial disclosure is the first actual building block of a broader regulatory strategy to foster corporate long-termism, the first legislative attempt to clarify what corporate long-termism is, and the first indication of how long-termism should be represented and to whom.

So "what are companies for?" The provocative question posed by *The Economist* might find several, complex and even imaginative answers. However, we must be realistic: "The way to make capitalism work better for all is not to limit accountability and dynamism, but to enhance them both" because "the purpose of companies should be set by the owners, not executives or campaigners".[119] It seems, once again, that more responsible corporate governance requires the active contribution of the shareholders.

[117] *See supra*, Part II, para. 4, and accompanying notes.
[118] *See* Leonardo Davoudi, Christopher McKenna & Rowena Olegario, *The historical role of the corporation in society*, 6(s1) J. BRIT. ACAD. 17, 24, 39 (2018).
[119] THE ECONOMIST, *supra* note 1, at 9.

Electronic copy available at: https://ssrn.com/abstract=3536460