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SEC heightens focus on climate-related disclosures and other ESG issues

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The recent flurry of U.S. Securities and Exchange Commission (SEC) activity in the climate risk and environmental, social, and governance (ESG) space is an indication that the agency is beginning to ramp up its efforts to address this emerging area of investor concern. Over the course of only a few weeks, the SEC announced a new task force to investigate misleading climate and ESG disclosures, appointed a senior advisor on climate and ESG issues, and instituted a review of its long-standing climate disclosure guidance.

Why the focus on ESG and climate?

Recent trends show that many investors care a great deal about corporate climate and ESG practices, and more and more investors believe those practices will affect a company's future profitability. As changes in the globe's climate continue to progress and social issues take a larger stage in society, many investors now demand greater disclosure of ESG plans and practices. Indeed, the risks associated with ESG issues — damaging weather events caused by climate change, serious health events like endemics or even a global pandemic, and attention or inattention to changing social norms — all can affect corporate performance. Moreover, investment managers have heard the call of investors and established funds focused solely on assets that abide by ESG principles.

However, as a truly emerging priority, there is a lack of standards and predictability in how these disclosures should be made. The SEC has established almost no mandatory disclosure of ESG information, beyond the federal securities laws' general standard that mandates the disclosure of material information that alters the "total mix" of information available to an investor. Further, where disclosure is made, the SEC has not set regulations that standardize the details of those disclosures. In adopting Regulation S-K modernizing amendments in 2020, the SEC considered but declined to establish prescriptive disclosure requirements relating to climate risks or diversity and other human capital issues, and instead continued with reliance on existing principles-based disclosure guidelines under general materiality standards and anti-fraud obligations. Moreover, numerous standard-setting organizations are promoting differing sets of metrics and disclosure standards, further complicating efforts to meet the disclosure expectations of various stakeholders.

Despite the lack of specific and easy-to-follow bright-line regulatory standards or a consistent voluntary reporting framework, corporations and funds have heard loud and clear from investors

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that they must make this information available to stay competitive. Regulators and lawmakers are hearing these calls as well, and are now responding at a rapid pace.

The SEC ramps up

Since the change in administration in January, the SEC appears to be getting on board with the emerging trend quickly. Among recent statements and actions are:

- On February 1, 2021, just 12 days after the inauguration of the Biden-Harris administration, Acting SEC Chair Allison Herren Lee, a vocal proponent of additional rules-based climate-related disclosure regulation, sent a clear signal by establishing the role of Senior Policy Advisor for Climate and ESG within her office and appointing Satyam Khanna to serve in the newly created position. Acting Chair Lee commented at the time that "having a dedicated advisor on these issues will allow us to look broadly at how they intersect with our regulatory framework across our offices and divisions."
- On February 24, 2021, Acting Chair Lee issued a directive to the staff of the SEC's Division of Corporation Finance (the Staff) to enhance its focus on climate-related disclosure in public company filings, indicating that the directive addresses "immediate steps the agency can take on the path to developing a more comprehensive framework" for "consistent, comparable and reliable" climate-related disclosures. Under this directive, the Staff is to: (1) undertake a review of the extent to which public companies address the topics identified in the 2010 SEC interpretive release regarding disclosure related to climate change (the 2010 Guidance); (2) assess compliance with disclosure obligations under the federal securities laws; (3) engage with public companies on climate-related disclosure issues; and (4) gather insight on how the market is managing climate-related risks. Based upon that review, the Division of Corporation Finance is tasked with updating the 2010 Guidance to ensure that investors receive the material information regarding these issues needed to adequately inform their investment decisions.
- On March 3, 2021, the SEC's Division of Examinations (formerly the Office of Compliance Inspections and Examinations, or OCIE) announced its 2021 examination priorities for investment companies, investment advisers, broker-dealers, and other financial services industry participants, which it noted include an enhanced focus on climate and ESG-related risks. Acting Chair Lee highlighted that the 2021 priorities include an examination of (1) investment adviser proxy voting policies and practices "to ensure voting aligns with investors' best interests and expectations," and (2) firm's business continuity plans "in light of intensifying physical risks associated with climate change."
- On March 4, 2021, the SEC announced creation of a Climate and ESG Task Force in its Division of Enforcement to address misleading statements in the disclosure of climate and ESG information by public companies and asset managers. Kelly Gibson, Deputy Director of Enforcement, will lead the task force, which includes 22 members from SEC headquarters and offices across the country, as well as Enforcement specialized units. In its press release about the announcement, the SEC explained that the task force will (i) develop initiatives to proactively identify ESG-related misconduct and (ii) coordinate the effective use of Enforcement resources to identify potential violations, including through "sophisticated data analysis to mine and assess information across registrants." The task force will also evaluate and pursue tips, referrals, and whistleblower complaints about ESG-related issues.
- On March 11, 2021, SEC Division of Corporation Finance Acting Director John Coates released a

public statement on regulation of ESG disclosure that provides some insight into the approach the SEC may take with respect to the development of a new ESG disclosure framework. Acknowledging the challenges of developing uniform metrics that will be relevant and meaningful for all reporting companies and investors, Acting Director Coates expressed his belief that SEC policy in this area will need to be "both adaptive and innovative." He also stressed the costs to reporting companies and investors of not having a consensus ESG disclosure system, and the importance of SEC leadership in addressing these issues. This statement follows earlier statements of Acting Director Coates which similarly indicated his support of updating existing ESG disclosure requirements.

Overview of the 2010 Guidance

The SEC's 2010 Guidance, which focused on the non-financial statement disclosure rules of Regulation S-K, was intended to provide clarity and enhance consistency regarding climate change disclosures under existing disclosure requirements. To assist public companies in satisfying their disclosure obligations with respect to material climate-related matters, the 2010 Guidance highlights considerations in four specific areas where the impact of a climate-related matter may trigger disclosure obligations pursuant to various items of Regulation S-K, including in a company's discussion of its business and operations, legal proceedings, risk factors, and Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). The four areas highlighted for consideration include:

- **Impact of legislation and regulation:** Is the actual or potential impact of existing or pending climate legislation or regulation material to the company's business, operations, or financial condition?
- **Impact of international accords:** What are the material risks or effects on the company's business from international climate change accords and treaties?
- **Indirect consequences of regulation or business trends:** Will legal, technological, political, or scientific developments regarding climate change create new opportunities or risks for the company, such as increased demand for generation and transmission of energy from alternative energy sources or decreased demand for services related to carbon-based energy sources?
- **Physical impacts of climate change:** What are the actual and potential material impacts of climate change on the company's business and performance; for example, changes in the availability of natural resources, damage due to severe weather events, or potential hazards to coastal operations or properties?

What to expect next

The SEC's recent actions and statements regarding ESG disclosure in general and climate-related disclosures specifically are clear indications of the agency's attention to the market's concern for accountability on these issues. We expect the SEC to continue to sharpen its focus on the disclosure of climate risk and other ESG topics as the market continues to make these issues a priority.

While the level of specificity is unknown for the moment, we fully expect to see additional or updated guidance on climate-related disclosures based on observations from the Staff's reviews of recent Form 10-K and other SEC filings and public statements by public companies. An increase in the number of Staff comment letters about climate-related disclosures is also likely. In addition, over a longer timeframe, it appears that proposed rulemaking on a new ESG disclosure framework

has become more likely, although we note that not all current SEC Commissioners appear to share the view that new requirements are needed.[1] As the SEC gains further knowledge and gathers greater intelligence about how companies are disclosing or not disclosing material impacts of and risks resulting from climate change, increased enforcement also will surely follow.

What should public companies do now?

In anticipation of heighted regulatory focus on climate-related disclosures, public companies should take action now to:

- **Take a fresh look at the 2010 Guidance and company filings —** Companies should review their operations and recent SEC filings in light of the 2010 Guidance and make a fresh assessment of whether the company's climate-related disclosures satisfy the principles discussed by the SEC in that release, as well as SEC guidance regarding MD&A disclosures, with particular attention to disclosures of known trends and uncertainties involving climate-related matters that, in management's view, will have, or are reasonably likely to have, a material impact on the company's liquidity, capital resources, or results of operations.
- **Review Public Statements —** In addition to reviewing disclosures in their SEC filings, companies should carefully review climate-related statements and metrics provided in their sustainability reports, press releases, website postings, and other publicly available materials to ensure consistency and accuracy. We expect that, as part of its review of company disclosures in documents filed with the SEC, the Staff will also review the company's other publicly available materials regarding these matters and will raise questions about any apparent inconsistencies.
- **Assess adequacy of controls —** Companies should review their controls and procedures to assess whether the adequacy and accuracy of disclosures relating to climate change, sustainability, and other ESG topics are adequately addressed, and to identify and address any gaps or inconsistencies in information reporting.
- **Inform and engage the board of directors —** It is a virtual certainty that demands for greater engagement, disclosure, and accountability on a broad range of ESG issues, including climate-related matters, from institutional investors and other stakeholders, including ESG-focused activists, will continue unabated. Boards of directors should ensure that they are receiving adequate information from management about these issues, and that appropriate risk oversight mechanisms have been established to address the issues, tailored to the company's particular circumstances.

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[1] See, for example, the joint Public Statement of Commissioners Hester M. Pierce and Elad L. Roisman, *Enhancing Focus on the SEC's Enhanced Climate Change Efforts* (March 4, 2021), available at: https://www.sec.gov/news/public-statement/roisman-peirce-sec-focus-climate-change.