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Snapshot

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SEC undertakes climate and ESG-related activity

The SEC recently announced several developments related to climate change and environmental, social, and governance (ESG) matters. While these initiatives were announced under the leadership of then Acting SEC Chair Allison Herren Lee, the SEC is expected to remain focused on climate change and ESG matters under Chairman Gary Gensler, who was sworn in on April 17. See the SEC's webpage for further information on its response to climate and ESG risks and opportunities.

Review of climate disclosures

In February, Ms. Lee issued a statement directing the staff of the Division of Corporation Finance (CorpFin) to enhance its focus on climate-related disclosures. CorpFin is tasked with reviewing how public companies are currently applying the 2010 guidance on climate-related disclosures and will use insights learned to update that guidance. Ms. Lee described these activities as "immediate steps the agency can take on the path to developing a more comprehensive framework that produces consistent, comparable, and reliable climate-related disclosures."

While any incremental disclosure requirements would take some time to undergo the SEC rulemaking process, in the near-term, registrants may see an increase in climate-related comments in SEC filing reviews. Accordingly, companies may want to review their disclosures against the 2010 guidance and current Regulation S-K requirements to proactively address any gaps in disclosure. The 2010 guidance outlines a number of potential impacts of climate change for registrants to consider when drafting disclosures. Many of the potential impacts identified in the 2010 guidance remain relevant today, including

- *Regulatory or legislative developments* – Today there are several climate-related initiatives under way in Congress as well as in the executive branch of the U.S. government, which may result in regulatory requirements aimed at curbing carbon emissions. For companies in energy-intensive industries, significant capital expenditures may be needed in order to meet emissions reduction targets. Energy companies themselves face a mounting challenge to implement sustainable business models that remain relevant in a zero-carbon economy. Meeting these challenges may require significant capital expenditures in new technologies, infrastructure, and/or carbon offset programs.
- *International accords* – The Biden Administration re-entered the Paris Climate Agreement earlier this year, which challenges each signatory to establish a plan to reduce its carbon emissions to net zero by 2050. In April, in connection with a climate summit attended by over 40 world leaders, the administration outlined its goal for the United States to reduce its carbon output to approximately 50 percent of its 2005 thresholds by 2030. As federal, state, and local governments outline plans to achieve these goals, many registrants are likely to be impacted, some materially so.
- *Indirect consequences of regulation or business trends* – Companies that are not directly impacted by regulatory or legislative developments may have suppliers that are directly impacted and may be exposed to price variability from suppliers

seeking to pass on some or all of their increased costs. Changes in consumer preferences in favor of sustainable goods and services may also create new opportunities for registrants that are well positioned to address such demand, as well as risks for those facing decreased consumer demand. Certain companies have voluntarily announced plans to achieve carbon net zero and, in some cases, are pressuring their suppliers to monitor and reduce carbon emissions.

- *Physical impacts of climate change* – The physical impacts of climate change could damage or destroy property or disrupt an entity's supply chain or the distribution of its goods and services. Certain industries may face a number of challenges. For example, agricultural operations may be adversely impacted by drought and increasing temperatures and may face diminishing access to natural resources, such as water. Also, insurers may face increased claims related to policies for properties in locations adversely impacted by climate change, while lenders may face increased credit risk associated with the potential decline in the value of impacted properties.

Given these potential impacts of climate change, registrants should ensure that their disclosures adequately address how climate change may impact their operations, financial position, and liquidity. Specific disclosures to consider include

- Regulation S-K, Item 101, *Business*, requires a principles-based description of the company's business, including material changes to a previously disclosed business strategy, trends in market demand and competitive conditions, the sources and availability of natural resources, and the "effects that compliance with government regulations, including environmental regulations, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries."
- Regulation S-K, Item 103, *Legal proceedings*, requires a brief description of any material pending legal proceedings, including disclosure of environmental proceedings with the government involving monetary sanctions that the registrant reasonably believes are likely to exceed either (1) $300,000, or (2) an alternative threshold based on materiality determined by the registrant, not to exceed $1 million or 1 percent of the registrant's consolidated current assets.
- Regulation S-K, Item 105, *Risk factors*, requires a discussion of the risk factors specific to the company that could make an investment in the company speculative. Risk factor disclosure should be specific to the entity and not include boilerplate language that could be broadly applicable to any registrant.
- Regulation S-K, Item 303, *Management's discussion and analysis of financial condition and results of operations*, requires the company to discuss and analyze its business from management's perspective. Management's Discussion and Analysis (MD&A) includes a discussion and analysis of historical results for each annual and interim period presented, liquidity, and capital resources, including material cash requirements and the anticipated source of funds, as well as material events, known trends, and uncertainties that are reasonably likely to cause reported financial information not to necessarily indicate a company's future operating results or future financial condition.

Registrants may find it challenging to determine whether a material trend or uncertainty should be disclosed in MD&A. In making this assessment, the registrant first analyzes whether a trend or uncertainty is reasonably likely to occur. If the answer is no, then no disclosures are required. However, if the trend or uncertainty is reasonably likely to occur or if a determination cannot be made, the registrant must evaluate the outcomes assuming that the trend or uncertainty will occur. Disclosure is required unless the trend or uncertainty is not reasonably likely to have a material impact on the financial condition or results of operations.

S-K Item 303 does not include a defined future time horizon over which the impact of a known trend or uncertainty should be evaluated. The 2010 climate-related guidance acknowledges this, noting that "As with any other judgment required by Item 303, the necessary time period will depend on a registrant's particular circumstances and the particular trend, event or uncertainty under consideration."

In addition to the specific disclosure areas listed above, the 2010 guidance also reminds registrants that Rule 408 of the Securities Act of 1933 and Rule 12b-2 of the Securities Exchange Act of 1934 require disclosure of "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."

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Climate-related disclosures required in a report filed under the Securities Exchange Act of 1934 are subject to an entity's disclosure controls and procedures (DCP). To ensure the completeness and accuracy of climate change disclosures, registrants may want to consider whether changes to DCP are warranted.

Registrants are encouraged to actively monitor legislative and regulatory developments as well as leading indicators of climate change impacts to their operations, such as changes in supplier pricing, shifts in demand for goods and services, or other business developments. For example, mounting pressure from key customers or investors to reduce carbon emissions may be an indicator of potential future changes to update a company's infrastructure or operations to less carbon-intensive processes. In evaluating its disclosures, the registrant should consider potential shifts in its business strategy, new or emerging risk factors, as well as how known trends or material uncertainties could impact its financial condition and operations.

Request for public input

In March, Ms. Lee issued a statement requesting public input on climate change disclosures from investors, registrants, and other market participants. The request was prompted by the growing demand by investors for disclosures of climate change-related risks, impacts, and opportunities. The statement includes a wide range of questions for respondents to consider, including

- How the SEC may best regulate, monitor, review, and guide climate change disclosure for the benefit of investors while providing adequate guidance to preparers
- The advantages and disadvantages of various approaches, including incorporating existing disclosure frameworks and standards, developing a single set of global standards, or exploring standards mutually developed by investors, registrants, and other market participants
- How climate-related disclosures should be enforced or assessed, including whether they should be subject to external assurance
- Whether climate-related disclosure is one component of a broader ESG-disclosure framework

Registrants and other market participants are encouraged to comment by June 13. Responses may inform any future proposed rules issued by the SEC in this area.

Other SEC activity

The SEC's Division of Examinations issued a Risk Alert to highlight observations of deficiencies and internal control weaknesses from recent examinations of investment advisers, registered investment companies, and private funds related to investment products and financial services that incorporate ESG factors. Observations included examples where the portfolio management practices were inconsistent with disclosures about the ESG approach or controls were inadequate to implement the client's ESG-related investing guidelines. The alert also identified best practices, including clear disclosures of the firms' specific approach to ESG investing and alignment with the firms' actual practices, as well as the use of compliance personnel that are well versed in the firms' ESG-related practices.

The Division of Examinations also issued its 2021 examination priorities, which include an enhanced focus on climate and ESG-related risks. In particular, exams will focus on proxy voting policies and practices to assess alignment between voting and investors' interests and expectations as well as on business continuity plans given the intensifying physical risks of climate change.

The SEC has also created the Climate and ESG Task Force within the Division of Enforcement, which will develop initiatives to proactively identify ESG-related misconduct. In particular, the task force will work to identify material gaps or misstatements in issuers' disclosure of climate risks under existing rules, as well as consider disclosure and compliance issues regarding ESG strategies of investment advisers and funds.

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