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SEC Kicks Off 2021 Agenda With Intense Focus on ESG Disclosures

The global COVID-19 pandemic, severe weather events, and the social unrest unleashed in the United States over the past year have amplified the role of Environmental, Social and Governance ("ESG") as a driving factor in decision making, capital allocation, pricing, and valuation assessments by investors, lenders, issuers, credit agencies, index providers, and exchanges. For its part, current leadership of the U.S. Securities and Exchange Commission ("SEC") has moved quickly and decisively to demonstrate the agency's intention to focus on ESG disclosures generally and climate change disclosures in particular.

A RENEWED FOCUS

Within weeks of her January 21, 2021 appointment as SEC Acting Chair, Allison Herren Lee created a new ESG-focused position within the Office of the Acting Chair. Satyam Khanna, the first Senior Policy Advisor for Climate and ESG, will advise on ESG matters and advance related initiatives across the SEC. On February 24, 2021, Lee directed the staff of the Division of Corporation Finance to "enhance its focus on climate-related disclosure in public company filings." Aiming to update the SEC's 2010 interpretive guidance regarding climate change, Lee instructed staff to review the extent to which public companies have addressed the topics mentioned in the guidance and to "assess compliance with disclosure obligations under the federal securities laws, engage with public companies on these issues, and absorb critical lessons on how the market is currently managing climate-related risks."

Acting Chair Lee's focus on ESG is not new. Criticizing the SEC's failure to address ESG in its 2020 amendments to Regulation S-K, then-Commissioner Lee remarked in August 2020: "It has never been more clear that investors need information regarding, for example, how companies treat and value their workers, how they prioritize diversity in the face of profound racial injustice, and how their assets and business models are exposed to climate risk as the frequency and intensity of climate events increase." In a November 2020 speech, entitled "Playing the Long Game," Lee reiterated that "regulatory involvement is needed to achieve standardized, comparable, and reliable disclosure in this critical area."

On March 15, 2021, Acting Chair Lee requested public input on the Commission's disclosure rules and guidance as they apply to climate change disclosures, whether and how they should be modified, and how the Commission can best regulate climate change disclosures. Most recently, Acting Chair Lee called for changes to shareholder proxy voting disclosures that would incorporate "soaring demand" for ESG investment strategies and revamp an "unwieldy, difficult to understand" system in a speech to the Investment Company Institute on March 17.

Acting Chair Lee's interest in enhanced ESG disclosure also follows on the heels of a recommendation by a subcommittee of the SEC's Investor Advisory Committee in May 2020, which urged the SEC to earnestly consider "an effort to update the reporting requirements of [SEC registered] Issuers to include material, decision-useful ESG factors." The subcommittee's recommendation maintained that the time has come to address this issue now, after close to 50 years of contemplation in one form or another.

Most notably, on March 4 Acting Chair Lee launched a new Climate and ESG Task Force within the SEC's Division of Enforcement. This Task Force is charged with "develop[ing] initiatives to proactively identify ESG-related misconduct" and coordinate Division resources to "mine and assess information across registrants to identify potential violations." Led by Acting Deputy Director of Enforcement Kelly L. Gibson, the Task Force will initially focus on identifying "material" gaps or misstatements in issuer disclosures of climate risks under existing rules, while also analyzing "disclosure and compliance issues relating to investment advisers' and funds' ESG strategies." A Division-wide effort composed of 22 SEC staff, the Task Force is expected to work closely with the Divisions of Corporation Finance, Investment Management, and Examinations.

PARTICULAR FOCUS ON THE "E"

In its 2010 guidance on climate change disclosures, the SEC noted that climate change can be relevant under a variety of existing rules and regulations, such as Regulation S-K itemized requirements for business narrative, legal proceedings, risk factors, and management discussion and analysis ("MD&A"). Contemporary legislative and regulatory developments regarding climate change led to the SEC reiterating the need to disclose potential corresponding risks under Regulation S-K.

Many commentators have suggested that carbon emissions are an appropriate measurement of an entity's contribution to climate change and therefore are likely to drive asset pricing. Notably, the 2010 guidance indicated that political developments regarding climate change can create opportunities and risks that might require disclosure in an issuer discussion of risk factors or MD&A. Here, the SEC guidance observed that political trends, among other things, may create indirect consequences or business opportunities stemming from changes in consumer demand for goods that reduce greenhouse gas emissions.[1] Political or social trends may also generate reputational damage, the SEC said, based on "the public's perception of any publicly available data relating to its greenhouse gas emissions."[2] Under the 2010 guidance, such reputational risks should be considered for risk factor disclosure.

DISCLOSURE REVIEW

The Division of Corporation Finance has issued relatively few comment letters relating to climate disclosures since the 2010 guidance was promulgated. Those comment letters have generally focused on the sufficiency of risk factor disclosure related to climate change and materiality assessments for MD&A disclosure. As to risk factor disclosure, comment letters have ranged from more general requests to add a climate change risk factor—or explain why one is unnecessary—to more detailed requests regarding potential compliance obligations under proposed regulations. For MD&A disclosure, some comment letters have highlighted inconsistencies between the discussion of climate risks in proxy statements and third-party environmental reports. For example, one comment letter addressed the adequacy of MD&A disclosures related to climate risks by pointing to the company's Carbon Disclosure Project (CDP) report that emphasized potential regulatory risks. That report, according to the comment letter, was largely inconsistent with an earlier proxy statement which minimized those risks. The comment letter therefore requested an explanation of the materiality assessment for the failure to address this discrepancy in the company's MD&A disclosures in its Form 10-K.

Regarding ESG more broadly, the Division of Investment Management has engaged with registrants through the comment letter process for registration statements relating to mutual funds and ETFs that discuss the role of ESG-related data in their investment decisions. Demands for funds to consider ESG-related data have risen among private equity investors, and some funds have sought to explain the role of such data in their registration statements. SEC comment letters in 2020 revealed an emerging trend toward demanding more detailed information regarding the role of ESG-related data in investment decisions as well as the sources of that data.

Recent comment letters have focused on whether and how funds rely on third-party providers to generate their ESG-related data. Letters have asked registrants, among other questions, whether investments are selected by reference to ESG indices, third-party rating organizations, or proprietary ESG-related screens. Reflecting a focus on the use of third-party ESG data, the SEC has asked funds to identify those third-party providers, to summarize their criteria or methodology in generating ESG data, and to identify potential related risks. Other areas of focus in comment letters have centered on how funds define ESG, specific ESG areas of focus, and whether ESG plays a predominant role in decision making.

The ESG filing correspondence from Investment Management provides insight into the areas that Corporation Finance might inquire in carrying out its recent directive to enhance its focus on climate-related disclosure and ESG more broadly. In conducting its heightened review of ESG disclosure, the Division of Corporation Finance might use a framework previously used by its Office of Global Security Risk ("OGSR"), which has been folded into its general filing review team. OGSR reviewed undisclosed business activities in U.S.-sanctioned countries. For years, the OGSR engaged with companies based on publicly available information—including news articles and their own websites—which implied ongoing or past business activities in sanctioned countries. When those activities were not disclosed in public filings, Corporation Finance used comment letters to gather more information. More specifically, those letters asked for: (1) a description of the "past, present, and anticipated contacts" with sanctioned countries; and (2) a discussion of the materiality assessment for those undisclosed business activities in "quantitative terms" and "qualitative factors" that a reasonable investor would deem important.

Staff can be expected to raise questions in comment letters about ESG-related factors when comparing disclosures in filings, particularly MD&A and Risk Factor disclosures, to Issuer's marketing materials, social media, website and news articles. If an issuer has self-published ESG reports, Division staff may seek enhanced information regarding how that data was compiled and the underlying methodologies employed using third-party reporting standards, including materiality assessments. Indeed, failure to disclose the underlying methodologies may lead to Corporation Finance asking about materiality assessments in both quantitative and qualitative terms.

Also, based on a recent speech by Acting Chair Lee, the Division of Corporation Finance may inquire about political spending. Speaking before the Center for American Progress on March 15, Acting Chair Lee asserted that political spending disclosure is linked to ESG issues based on research suggesting that some companies made climate pledges while contributing to the campaigns of political candidates with contradictory voting records. While acknowledging that the SEC "is currently prevented from finalizing a rule in this area," she emphasized the need to consider whether investors can "adequately test" ESG commitment claims "without political spending disclosure requirements."

A NEW ERA OF ENFORCEMENT AND EXAMINATIONS?

Given the Biden Administration's broader commitment to advancing a climate change agenda, the current SEC focus on ESG is not surprising. But the SEC's recent actions have left public companies, investors, and other stakeholders wondering what this enhanced focus on climate (and ESG more broadly) will entail. Under former Chairman Clayton, there were no enforcement actions that specifically charged deficiencies in climate-related disclosures, and at least one investigation into an issuer's climate risk disclosures was reportedly closed without enforcement action. The announcement of the ESG Task Force housed within the Division of Enforcement – as compared to the SEC's COVID-19 Market Monitoring Group, which was comprised of nearly all policy Divisions at the Commission *except* Enforcement – may herald a tidewater shift regarding enforcement for climate risk disclosures, even under the current guidance. John Coates, Acting Director of the Division of Corporation Finance and a former member of the SEC Investor Advisory Committee that urged the SEC to act "in earnest" to update ESG reporting requirements, has publicly suggested that, under longstanding concepts of materiality, investor demand for sustainability reports is transforming what was once voluntary into something "less voluntary." "The SEC is well equipped to lead and facilitate a discussion on when and how ESG risks and data must be disclosed," Coates remarked on March 11. The goal, he asserted, is to "create and maintain an effective ESG-disclosure system that would promote the disclosure of decision-useful, reliable, and, where appropriate, globally comparable ESG information."

In addition, the newly-renamed Division of Examinations recently announced an increased focus on climate and ESG-related risks as part of its 2021 examination priorities. While looking for "maturation and improvements" in the business plans and disclosures of investment advisers regulated by the SEC, the Division wants registrants to account for the "growing physical and other relevant risks associated with climate change." The 2020 examination priorities revealed a new focus by Examinations on the "accuracy and adequacy of disclosures provided by [registered investment advisers] offering clients new types or [sic] emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate environmental, social, and governance (ESG) criteria." Examinations staff have issued ESG-related document requests in recent years that have generally focused on similar questions as Investment Management but included other targeted requests regarding performance. Those unique requests included identification of ESG investments made or recommended, the ESG scoring for each, and the returns on those ESG investments. Other questions have centered on ESG marketing materials aimed at current or prospective investors and internal processes and policies including compliance evaluations and internal audits related to ESG investments. This category of request appears most prevalent when the fund or entity subject to examination has marketing or disclosure materials that reference a special focus or interest in ESG investments or related matters.

The 2021 priorities, however, provide more insight into the specific areas of focus, as the "Division will focus on products in these areas that are widely available to investors such as open-end funds and ETFs, as well as those offered to accredited investors such as qualified opportunity funds." For those products, review will be centered around the consistency and adequacy of disclosures provided to clients regarding their ESG-driven investment strategies, the presence of any false or misleading statements, and proxy voting policies to "assess whether they align with the [ESG] strategies." We expect that there will be a number of enforcement referrals emanating from Examination's heightened and targeted focus that will likely involve examination findings of incomplete, inaccurate or inconsistent disclosures, in particular where the investment adviser's practices do not match its disclosures; and/or findings that the investment adviser has inadequate policies and procedures around its ESG strategies to appropriately monitor or measure its investments in light of its disclosure.

With ESG informing so-called "impact investing" strategies and underpinning more traditional investment analyses as businesses compete for capital based on ESG performance, perhaps we will see increased enforcement around fossil fuel investment accounts or more accountability of companies touting ESG accomplishments. Or perhaps we will see the SEC partnering with other regulatory agencies to highlight the ESG angle in otherwise standard enforcement actions. Either way, with the creation of the new Task Force and other recent pronouncements appearing to signal an aggressive ESG-focused enforcement program, we can anticipate enhanced enforcement scrutiny based on the existing disclosure regime.

Given the recent announcement that the ESG Task Force will "coordinate the effective use of Division resources, including through the use of sophisticated data analysis to mine and assess information across registrants," it is clear that the Task Force plans to make use of its many data analytic tools. One possible tool is CIRA, Corporate Issuer Risk Assessment program, an enhanced version of the Accounting Quality Model that was developed by the Division of Economic and Risk Analysis (DERA) to detect anomalous patterns in financial reporting and is now used to identify situations or activities at corporate filers that warrant further inquiry. The data comes from XBRL filings and commercial databases.

We also anticipate that enforcement will receive referrals from the Division of Corporation Finance that, as described above, uses data analytics as well in connection with its filing review program.

Commissioners Hester M. Peirce and Elad L. Roisman, however, have stated that "it's not yet clear" what the newly announced "'enhanced focus' on climate-related matters mean[s]." In a March 4 public statement, Peirce and Roisman explained that "time will tell" whether the announcements "represent a change from current Commission practices or a continuation of the status quo with a new public relations twist." Given the SEC's longstanding acknowledgement of climate-related issues, they explained, the new initiative should be viewed "simply [as] a continuation of the work the staff has been doing for more than a decade and not a program to assess public filers' disclosure against any *new* standards or expectations." Commissioners Peirce and Roisman also asserted it may be "more prudent for us to await the results of the Corporation Finance staff's latest review of climate change-related disclosures" before "allocating resources to an ESG-*specific* enforcement initiative." While the effect of these announcements remains to be seen, Commissioners Peirce and Roisman reminded that "we must continue to review any alleged securities violations in light of the regulations and guidance *in existence* at the time of the conduct in question."

CONGRESSIONAL INTEREST IS PIQUED

Regardless of whether recent SEC announcements presage a bold new and focused approach to ESG disclosures or merely a continuation of the status quo, we know Congressional interest in this space is intense. As far back as 2019, then-Chairwoman of the U.S. House Committee on Financial Services Carolyn Maloney urged the SEC in a hearing on a proposal to improve ESG disclosures, to establish ESG disclosure standards because "ESG disclosures often aren't as detailed as they should be." More recently, current Chairwoman Maxine Waters held a hearing on February 25, 2021 entitled "Climate Change and Social Responsibility: Helping Corporate Boards and Investors Make Decisions for a Sustainable World." Covering topics such as board diversity, climate change disclosures, corporate power, political contributions, regulatory burdens, and international tax disclosures, Chairwoman Waters emphasized her view of the need to use "climate as a bridge to equality." And the Committee on Banking, Housing, and Urban Affairs held a hearing on March 18 entitled, "21st Century Economy: Protecting the Financial System from Risks Associated with Climate Change."

Several proposed bills show the focus Congress is placing on ESG disclosures. Examples include:

- H.R. 1187, "**ESG Disclosure Simplification Act of 2021**" (Rep. Juan Vargas, D-CA-51 and Rep. Jesus "Chuy" Garcia, D-IL-04)), which would establish new disclosure requirements regarding ESG metrics and create a Sustainable Finance Advisory Committee within the SEC that would make recommendations on which ESG metrics public companies should be required to disclose.
- H.R.____, "**Paris Climate Agreement Disclosures Act**" (Rep. Nydia M. Velazquez, D-NY), which would require the SEC to promulgate a rule compelling public companies to disclose the steps they are taking to be in compliance with the temperature goals of the Paris Climate Accord.
- H.R. 3623, "**Climate Risk Disclosure Act**" (Rep. Sean Casten, D-IL-06), which would require public companies to disclose in their annual reports information relating to the financial and business risks associated with climate change. The bill would also require the SEC to establish, in consultation with other relevant Federal agencies, climate-related risk disclosure metrics and guidance, which will be industry-specific, and will require companies to make both quantitative and qualitative disclosures.
- H.R. 5084, "**Improving Corporate Governance Through Diversity Act of 2021**" (Rep. Gregory W. Meeks, D-NY-5), which would require public companies to disclose racial, ethnic, and gender compositions of their boards of directors and executive officers, in addition to veteran status. This bill also directs the SEC to establish a Diversity Advisory Group, while requiring covered companies to disclose any plans to promote diversity.

LOOKING AHEAD

On March 10, the Senate Banking Committee voted 14-10 in favor of sending Gary Gensler's nomination for chairman of the SEC to the Senate floor for confirmation. Although it cannot be certain whether expected-Chair Gensler will be in lockstep with the ESG views of Acting Chair Lee or may align somewhere between those views and those of Commissioners Peirce and Roisman, it is reasonable to expect that given the public priorities of the Biden administration, Gensler will continue to advance broader ESG initiatives at the SEC. Many anticipate that upon his expected confirmation, Gensler will likely direct SEC staff to actively monitor anti-greenwashing rules that took effect in Europe on March 10. These are rules that prevent a fund from misleadingly labeling itself as "eco" or "sustainable" to attract environmentally minded investors. These rules also require investment firms managing money in the European Union to disclose whether they are reviewing the environmental and social impacts of their investments based on 18 metrics. Just how far past the ESG policies of his predecessor, Jay Clayton, Gensler will push the SEC, whether by rulemaking, enforcement, or public policy, remains to be seen.

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[1] Commission Guidance Regarding Disclosure Related to Climate Change, 75 Fed. Reg. 6290 (Feb. 8, 2010) *available at* https://www.sec.gov/rules/interp/2010/33-9106.pdf, at 25-26.
[2] *Id.* at 26.