SEC Continues its March Toward a New Climate and ESG Disclosure Framework

March 31, 2021

In recent weeks the U.S. Securities and Exchange Commission (the "Commission" or "SEC") has moved forward with a series of initiatives related to climate and other environmental, social and governance ("ESG") matters.[1] Most recently, on March 15, 2021, in a speech delivered at the Center for American Progress, SEC's Acting Chair Allison Herren Lee identified climate and other ESG initiatives and disclosures as important areas of focus for the Commission in response to increased investor demand. The Acting Chair requested public input on what a climate- and other ESG-specific disclosure framework might look like. The speech cited the historical and continuing trend of increased investor demand for climate and other ESG-focused sustainable investments, and challenged the commonly held narrative that investing for "good" causes and investing for profit are rarely aligned.[2] Lee also emphasized that specific investor concerns about climate and other ESG disclosure issues closely align with key priorities of the Commission in the areas of investor protection, investor confidence in market stability and enforcement of cybersecurity standards.

The Commission's actions, coming on the heels of the Biden administration's strongly worded shift in favor of increased environmental regulation, has already elicited a first wave of responses from the investing community. Market leaders are responding to investors that increasingly place greater value on climate and other ESG factors in making investment decisions. At the same time, they are expressing concern that the Commission's public statements regarding its climate and other ESG initiatives create the potential for market uncertainty over whether compliance with existing Commission guidance remains sufficient and what additional steps, if any, industry participants should consider taking in anticipation of the pending updated disclosure framework.

[1] Recent ESG-related actions include, among others, (1) the appointment of Satyam Khanna as the Senior Policy Advisor for Climate and ESG on February 1, 2021, sec.gov | Satyam Khanna Named Senior Policy Advisor for Climate and ESG, (2) the SEC announcing enhanced review of climate-related disclosures in public company filings on February 24, 2021, sec.gov | Statement on the Review of Climate-Related Disclosure, and (3) the SEC announcing the creation of an ESG and Climate Task Force in the Division of Enforcement on March 4, 2021, sec.gov | SEC Announces Enforcement Task Force Focused on Climate and ESG Issues.

[2] *A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC*, Allison Herren Lee (March 15, 2021) ("Meeting Investor Demand"), available at sec.gov | A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC**.**

Absence of Information

Under the existing framework, disclosure for climate and other ESG initiatives is currently voluntary. The problem with this approach, in Lee's view, is that a voluntary approach is insufficient for meeting the demands of investors who are seeking more fulsome and comparable climate and other ESG disclosures**.** This is because the necessary information to conduct a comparison of different investment opportunities is often absent from disclosure materials. Lee announced an expectation that the Commission will take several steps in response to this perceived deficiency. First, the Commission staff will conduct a fresh review of existing company disclosures and compare them against disclosure guidelines on climate change issues provided by the Commission in 2010, as well as compliance with other existing disclosure requirements. Next, the Commission will request public comment on climate disclosure in order to obtain market input. To this end, also on March 15, the Commission published questions for public comment, the responses to which could then provide the basis for creating an effective and flexible framework for climate disclosures.[3]

In framing the request for public input, the Acting Chair expressed concern that the 2010 climate change guidance does not go far enough in terms of adequately addressing investor concerns about the unique and detailed risks and strategies concerning climate change. For this reason, following the SEC Investor Advisory Committee's May 2020 recommendation that the Commission begin updating reporting requirements to reflect material ESG factors**,** and the December 2020 recommendation by the ESG Subcommittee of the SEC Asset Management Advisory Committee that the Commission require standards for disclosing material ESG risks, Lee asked the staff to evaluate current disclosure rules with the goal of improving the disclosure of important climate change-related information. Asking the public for input, the statement lays out a list of broad questions identifying the types of issues and concerns the Commission is hoping to address, many of which focus on standardizing disclosures and increasing the breadth, reliability, and comparability of such information:

- "How can the Commission best regulate, monitor, review, and guide climate change disclosures in order to provide more consistent, comparable, and reliable information for investors while also providing greater clarity to registrants as to what is expected of them? Where and how should such disclosures be provided? Should any such disclosures be included in annual reports, other periodic filings, or otherwise be furnished?"[4]
- "What is the best approach for requiring climate-related disclosures? For example, should any such disclosures be incorporated into existing rules such as Regulation S-K or Regulation S-X, or should a new regulation devoted entirely to climate risks, opportunities, and impacts be promulgated? Should any such disclosures be filed with or furnished to the Commission?"[5]
- "How, if at all, should registrants disclose their internal governance and oversight of climate-related issues? For example, what are the advantages and disadvantages of requiring disclosure concerning the connection between executive or employee compensation and climate change risks and impacts?"[6]
- "What climate-related information is available with respect to private companies, and how should the Commission's rules address private companies' climate disclosures, such as through exempt offerings, or its oversight of certain investment advisers and funds?"[7]
- "In addition to climate-related disclosure, the staff is evaluating a range of disclosure issues under the heading of environmental, social, and governance, or ESG, matters. Should climate-related requirements be one component of a broader ESG

[3] *Public Input Welcomed on Climate Change Disclosures*, Allison Herren Lee (March 15, 2021) ("Public Input"), available at [sec.gov | Public Input Welcomed on Climate Change Disclosures]

[4] Public Input, 2021.
[5] Public Input, 2021.
[6] Public Input, 2021.
[7] Public Input, 2021.

disclosure framework? How should the Commission craft climate-related disclosure requirements that would complement a broader ESG disclosure standard? How do climate-related disclosure issues relate to the broader spectrum of ESG disclosure issues?"[8]

In addition to the questions above, Acting Chair Lee tied in the importance of political spending disclosure in evaluating climate and other ESG investment concerns, despite what she acknowledged as the Commission's lack of authority to promulgate a rule on disclosing such information.

Shareholder Rights

Lee highlighted the shareholder proposal and proxy voting as two of the most vital tools that protect the rights of investors and provide an avenue for consideration and implementation of their ideas and suggestions. The Acting Chair has instructed Commission staff to develop proposals to revise current guidance on the no-action relief process, hoping to ensure greater clarity and "increase the number of proposals on the ballot that are well-designed for shareholder deliberation and votes."[9] Lee identified two potential ideas as reversing the 2020 decision that prohibited the aggregation of shares to meet eligibility requirements, or "reaffirming that proposals cannot be excluded if they concern socially significant issues."[10]

When it comes to proxy voting, Lee showed concern for situations in which investment fund fiduciaries vote proxies on behalf of their investors, yet may not always reflect investors' preferences for ESG strategies when voting. She pointed to several steps taken to emphasize proxy voting as part of funds' and advisers' fiduciary obligations as well as ensure transparency and fairness around the process. The Commission staff was instructed to consider the following:

- Recommendations for altering guidance published in August 2019 that instructs advisers on how to weigh client concerns, rather than discouraging them from voting entirely.
- Updates to disclosure of fund voting decisions, primarily through the review and a potential update to Form N-PX, on which fund voting decisions are filed.
- "Whether to recommend that the Commission re-open the comment file on the 2016 universal proxy rule proposal" that would require universal proxy cards in contested director elections.[11]

Corporate Accountability

Acting Chair Lee detailed several actions taken to help the Divisions of Examinations and Enforcement offer support to facilitating corporate accountability. The Division of Examinations 2021 priorities will focus on climate and other ESG issues, such as ESG fund proxy voting policies and practices and firms' plans in response to potential risks associated with climate change. The Commission formed a Climate and ESG Task Force under the Division of Enforcement, which will review for climate- and other ESG-related misconduct and false or omitted disclosure of certain risks.

Engagement and Cooperation

Lee stressed the importance of working with other domestic and international regulators to effectively address climate and other ESG-related risks and market concerns. In particular, she praised the International Organization of Securities Commissions' recent statement concerning the creation of a Sustainability Standards Board, which has potential to move toward an international baseline of sustainability reporting for countries to draw on in forming their own regulations. She also imagined the creation of similar domestic standard setters under Commission oversight, and warned of the risks of treating these issues as a solely domestic concern, without keeping an eye on the global market and regulatory landscape.

Acting Chair Lee concluded her remarks by maintaining that despite the specific and unique concerns and opportunities presented by climate and other ESG-related regulations, such concerns and opportunities squarely fit into the Commission's wider focus on retail investor protection and market fairness. Her statements

[8] Public Input, 2021.
[9] Meeting Investor Demand, 2021.
[10] Meeting Investor Demand, 2021
[11] Meeting Investor Demand, 2021.

follow a long trend of Commission focus on the particular risks she highlighted. The most recent examples are the formation of the Climate and ESG Task Force in the Division of Enforcement and the Division of Examinations 2021 examination priorities, as mentioned above, both of which focus on climate and other ESG-related risks and investor concerns, and evidence the Commission's taking further steps to directly respond to investor and market trends.

Claims That Climate and Other ESG Initiatives Politicize the SEC

It is important to recognize that not all the Commission's commissioners support the steps the Commission is announcing with respect to climate and other ESG initiatives. In fact, the Commission's two Republican commissioners, Commissioners Hester M. Peirce and Elad L. Roisman, in a statement published on March 4, 2021, previously questioned the Commission's commitment to focus resources on enforcing climate- and other ESG-related disclosure regulations, and echoed these same concerns at the first meeting of the Commission's ESG Subcommittee held after Lee's speech.[12] Among other concerns, the two commissioners asserted that the SEC's recent announcements have not clearly stated how this enhanced focus on enforcement of climate- and other ESG-related disclosure issues would differ, if at all, from the standards for enforcement based on existing guidance including the 2010 guidelines.[13] Commissioners Peirce and Roisman also claim that, without providing any clear-cut solutions, the announcement could harm the market by creating uncertainty on how to respond to these new initiatives.[14] When taken together with other government initiatives regarding climate and other ESG-related issues, we are already seeing significant shifts in certain key industries as certain participants choose not to wait to see the outcome of new regulatory initiatives. One notable example, which comes from the insurance industry, is the direction by Lloyd's of London in December 2020 to its managing agents to phase out insurance coverage for certain coal and oil activities beginning on January 1, 2022. The aim is to completely phase out the renewal of existing coverage for such activities by January 1, 2030.[15] As and when other insurance companies follow suit, their collective action will have a ripple effect throughout the global economy including the markets that are regulated by the Commission.

Looking Ahead

As there are yet to be any concrete examples of exactly how the Commission plans to enforce climate and other ESG disclosure deficiencies under its new initiatives, many issuers are instead focusing their compliance and disclosure efforts by drawing on guidance from other areas of recent concentrated focus by the SEC. This includes the existing voluntary climate and other ESG disclosure guidelines and the Commission's ever present focus on fraud more generally, particularly in the case of "materiality" issues (including the Commission's specific concern with "kitchen sink" disclosures and demands that registrants provide more registrant-specific risk factors). These all strongly suggest that the SEC will demand that in the area of climate- and other ESG-focused disclosures, registrants go beyond a standard description of general physical and reputational risk that such factors could pose to investors. It is telling that in its first meeting held after Lee's speech, in discussing some of the questions raised, the Commission's ESG Subcommittee concluded that the process of developing a new disclosure framework around climate and other ESG issues must begin by recognizing the uniqueness of ESG "information" itself. The subcommittee further agreed that the Supreme Court's definition of materiality, which provides that information is material when a reasonable investor would view the omission or misstatement of such information as having "significantly altered the total mix" of available information with respect to a potential investment, must remain a guiding principle of any such disclosure framework. The subcommittee concluded, much as the market more generally has, that many important questions and issues remain in terms of still-evolving ideas around climate and other ESG risks, including how to calibrate the costs

[12] An Honest Conversation about ESG Regulation https://www.sec.gov/news/speech/roisman-amac-2021-03-19.

[13] *Enhancing Focus on the SEC's Enhanced Climate Change Efforts*, Hester M. Peirce, Elad L. Roisman (March 4, 2021) available at sec.gov | Enhancing Focus on the SEC's Enhanced Climate Change Efforts.

[14] Peirce, Roisman, at 1.

[15] Howard, L., 2020. *Lloyd's Moves to End Insurance and Investments in Coal for Climate Sustainability*. [online] Insurance Journal. Available at: https://www.insurancejournal.com/news/international/2020/12/17/594394.htm

and expertise necessary for companies to effectively and accurately evaluate climate and other ESG risks, and the need for flexible standards that come with particular safe harbors to help compensate for the varying types of disclosure standards that might be appropriate for different types of issuers.
This alert should serve as a reminder of the risks and issues associated with complying with evolving SEC disclosure standards and anticipating potential enforcement actions in general and may be a harbinger of a coming wave of enforcement actions focused on identifying climate- and other ESG-related disclosure deficiencies. As such, market participants should review their existing compliance and disclosure programs in light of the SEC's enhanced focus on climate- and other ESG-related matters and update or bolster such programs as needed.

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This alert does not purport to contain a complete description of the SEC's recent initiatives regarding climate and ESG. For more information regarding these initiatives and how they might impact you, please contact any of the authors.

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