Don't wait until the SEC staff asks you about climate change

For investors, despite an abundance of ESG data, there is often a lack of consistent, comparable, and reliable ESG information available upon which to make informed investment and voting decisions.

– John Coates, Acting Director, Division of Corporation Finance, March 11, 2021

Voices from an increasing number of contingents extoll the merits of a new age of environmental consciousness. Vocal in the crowd, investors and other stakeholders across the business spectrum see environmental, social, and governance (ESG) disclosures as a window into a company's future. Shareholder proposals related to environmental impact are on the rise in number and level of support. And if companies weren't already acutely aware of the need to moderate their impact on the environment, many are voluntarily responding to stakeholder demand and increasingly making climate-related commitments—net zero, carbon neutral, carbon negative. Some of these commitments and other climate-related impacts are disclosed on websites or in speeches, sustainability reports, or survey responses, which may stand in stark contrast to what is (or isn't) said in a company's SEC filings.

The SEC is responding to the increased disparity between public statements and what's included in regulatory filings with increased attention on the quality and adequacy of disclosure. Issuers of securities are required to make material disclosures to facilitate investors' informed decision making. Of course, what constitutes a material disclosure that informs decision making is subject to significant management judgment. And while management is responsible for determining what is material and ultimately disclosed in its filings, the SEC staff is charged with assessing those disclosures for compliance with the federal securities laws.

February	March	What's next?
Allison Herren Lee, Acting Chair of the SEC, directed the Division of Corporation Finance to *increase its focus* on climate-related disclosures in company filings, basing reviews on the SEC's 2010 interpretive guidance. The Division of Enforcement *established* a Climate and ESG Task Force to scrutinize any material gaps or misstatements in issuers' disclosures under the existing rules.	In Gary Gensler's hearing for confirmation as SEC chair, he answered a significant number of questions on his views about mandatory disclosures for publicly-traded companies, including disclosures related to the impact of climate change. Gensler repeatedly cited the importance of disclosures that are supported by economic analysis and an assessment of materiality, stating that if the information is something investors want to know, then it could be material.	The SEC is looking to update its 2010 guidance. Companies should understand that even if they have taken steps in the past to evaluate the applicability of the 2010 guidance, these disclosures are not one and done. They should change over time as the company's facts and circumstances evolve. Now is the time to understand what's already required—even before the SEC staff asks and well before any new rules that might be issued. If you understand the objective, you'll be in a better position to comply even if the SEC revisits its rules.

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An old story with a renewed focus and an eye toward change

In its 2010 interpretive release outlining how existing disclosure requirements apply to climate change matters, the SEC noted that "climate change has become a topic of intense public discussion in recent years," which is a sentiment equally, even more, appropriate today. But even the 2010 guidance was nothing new. Since the 1970s, the SEC has asked for climate-related disclosures. After 40 years of developments, the SEC provided a roadmap in 2010 that summarized how existing requirements apply to climate-related risk.

1971
Release No. 33-5170

Required disclosure of the financial impact of compliance with environmental laws, based on the materiality of the information.

1973
Release No. 33-5386

Required disclosure of the material effects that compliance with environmental statutory provisions may have upon capital expenditures, earnings, and the company's competitive position.

Required disclosure of administrative or judicial environmental proceedings, including the factual basis and relief sought in the proceeding.

1976
Release No. 33-5704

Required disclosure of any material estimated capital expenditures for environmental control facilities.

1982
Release No. 33-6383

The SEC integrated the disclosure systems under the various Federal securities laws and simplified and improved the disclosure requirements imposed under those systems resulting in rules generally as written today.

2010
Release Nos. 33-9106; 34-61469

SEC's reminder that climate-related disclosures are important and that material impacts should be disclosed to comply with existing SEC rules.

This is the guidance Acting Chair Allison Herron Lee referenced in her February remarks.

1970 | 1980 | 1990 | 2000 | 2010 | 2020

We are long past the point at which it can be credibly asserted that climate risk is not material.

– Commissioner Allison Herron Lee, Regulation S-K and ESG Disclosures: An Unsustainable Silence, August 26, 2020

Today's focus

Climate change creates direct and indirect risks for companies in nearly all industries. Investors want to know about risk because it informs their decision making. The SEC is acknowledging the growing interest in ESG disclosures and reminding companies how they are already obligated to consider the impact of climate change in their current disclosures.

What does this "enhanced focus" on climate-related matters mean? The short answer is: it's not yet clear.

– Commissioner Hester Peirce and Commissioner Elad Roisman, Enhancing Focus on the SEC's Enhanced Climate Change Efforts, March 4, 2021

The following table summarizes the Regulation S-K requirements highlighted by the SEC in 2010. Companies have a responsibility to assess whether a material exposure in the following areas merits disclosure, and audit committees should understand management's assessment.

Regulation S-K Item	Disclosures applicable to climate-related matters
Description of business **Item 101** requires a registrant to describe its business and that of its subsidiaries.	• The material 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, including the estimated capital expenditures for environmental control facilities • Resources material to a registrant's business, such as sources and availability of raw materials
Legal proceedings **Item 103** requires a registrant to briefly describe any material pending legal proceeding to which it or any of its subsidiaries is a party.	• Administrative or judicial proceeding arising under any Federal, State, or local provisions regulating the discharge of materials into the environment or for the purpose of protecting the environment if certain materiality thresholds are met
MD&A **Item 303** requires disclosure known as the Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A.	• No specific MD&A requirements related to climate, but registrants must identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on their financial condition or operating performance
Risk factors **Item 105** requires a registrant to provide a discussion of the material factors that make an investment in the registrant or offering speculative or risky.	• Does not refer specifically to environmental risks, but requires all risks to be disclosed if significant to the company or the offering • May require disclosure regarding existing or pending legislation or regulation that relates to climate change

Foreign private issuers (FPIs)

While FPIs are not subject to Regulation S-K, Form 20-F includes similar provisions that may require disclosures related to climate change:

- Item 3.D requires the disclosure of material risks.
- Item 4.B.8 requires a description of the material effects of government regulation on the business.
- Item 4.D requires a description of environmental issues that may impact how a company uses its assets.
- Item 5.D requires disclosure of any known trends, uncertainties, demands, commitments, or events reasonably likely to have a material effect on the company's financial condition and results of operations.
- Item 8.A.7 requires information on any legal or arbitration proceedings that may have or have had significant effects on the company's financial position or profitability.

> If certain information that happens to fall in any of the ESG categories is material to that company, the company needs to disclose it. We expect management and the board to do that, and we will come after them when they don't.
>
> – Commissioner Elad Roisman, Keynote Speech at the Society for Corporate Governance National Conference, July 7, 2020

In its 2010 guidance, the SEC included the following examples of the types of events that may require disclosure under one or more of the Regulation S-K rules. These are only examples and registrants should consider their own circumstances, and consider discussion with SEC counsel, within the context of the SEC's rules and requirements.

Impact of legislation and regulation

- Costs to purchase, or profits from sales of, allowances, or credits under a "cap and trade" system
- Costs required to improve facilities and equipment to reduce emissions in order to comply with regulatory limits or to mitigate the financial consequences of a "cap and trade" regime
- Changes to profit or loss arising from increased or decreased demand for goods and services produced by the registrant arising directly from legislation or regulation, and indirectly from changes in costs of goods sold

International accords

- The impact of treaties or international accords relating to climate change, if material to the business (e.g., the Kyoto Protocol, the EU emissions trading system)

Indirect consequences of regulation or business trends

- Decreased demand for goods that produce significant greenhouse gas emissions
- Increased demand for goods that result in lower emissions than competing products
- Increased competition to develop innovative new products
- Increased demand for generation and transmission of energy from alternative energy sources
- Decreased demand for services related to carbon based energy sources, such as drilling services or equipment maintenance services

Physical impacts of climate change

- The effects of climate change on the severity of weather (for example, floods or hurricanes), sea levels, the arability of farmland, and water availability and quality, have the potential to affect a registrant's operations and results.
- Consequences of severe weather include:
  - For registrants with operations concentrated on coastlines, property damage and disruptions to operations, including manufacturing operations or the transport of manufactured products
  - Indirect financial and operational impacts from disruptions to the operations of major customers or suppliers from severe weather, such as hurricanes or floods
  - Increased insurance claims and liabilities for insurance and reinsurance companies
  - Decreased agricultural production capacity in areas affected by drought or other weather-related changes
  - Increased insurance premiums and deductibles, or a decrease in the availability of coverage, for registrants with plants or operations in areas subject to severe weather

In addition, the SEC issued guidance that became effective in February 2020 related to the use of key performance indicators and metrics in MD&A. In that release, the SEC noted that some companies voluntarily disclose environmental metrics. The main intent of the release was to remind companies that when disclosing metrics, further information may be necessary under existing MD&A requirements to make the presentation of the metric not misleading. According to the SEC, adequate context for an investor to understand the disclosed metric would generally be expected to include:

- a clear definition of the metric and how it is calculated;
- a statement indicating the reasons why the metric provides useful information to investors; and
- a statement indicating how management uses the metric in managing or monitoring the performance of the business.

Disclosure of the estimates or assumptions underlying the metric or its calculation may also be necessary context for the metric.

The following are examples of SEC staff comments that were issued for periods following the release of the SEC's 2010 guidance. These are not recent comments, but may be helpful in understanding how Corp Fin's focus may manifest in letters to registrants.

> "Please consider revising to include a risk factor and/or MD&A disclosure discussing how climate change may, if material, impact your company's business. Such disclosure should discuss the impact on your business of climate change regulation as well as the physical effects and business trends caused by climate change. Please refer to SEC Release 34-61469 (Feb. 8, 2010) regarding climate change matters. If you considered the Release and determined that information regarding the impact of climate change on your business was not material disclosure, please tell us why you determined it was not necessary.

> "To the extent that you believe your business may be vulnerable to climate related events, please revise your disclosure to describe these risks. See the Commission's Guidance Regarding Disclosure Related to Climate Change, Interpretive Release No. 33-9106 (February 8, 2010).

> "Please consider including a risk factor in your disclosure highlighting any material risks to your operations presented by possible increases in global temperatures widely attributed to climate change, as well as the atmospheric effects that have also been linked to this phenomenon. In your evaluation, please also consider the possible impact that proposed legislation in the United States intended to mitigate the effects of climate change might have on your operations. If you believe that climate change and any legislation that might be adopted to alleviate it does not currently materially affect you, please provide us with an analysis supporting this opinion.

> "You state in your proxy statement that you currently consider regulatory risks around air and greenhouse gas emissions to have no significant unmanageable impacts to your operations. Please reconcile this assertion with your description of the climate change risks from your CDP Report as having a "high" impact on your business and provide your analysis as to why you believe such "uncertaint[ies]" do not constitute known trends or uncertainties requiring disclosure pursuant to Item 303(a) of Regulation S-K.

Final thoughts

When the SEC's guidance was issued in 2010, the stated purpose was to "remind companies of their obligations under existing federal securities laws and regulations to consider climate change and its consequences as they prepare disclosure documents to be filed with [the SEC] and provided to investors." In our current culture of enhanced environmental focus and demands from both regulators and legislators for increased transparency, Acting Chair Lee's reminder last month about the 2010 guidance appears to be intended for the same reason.

There is an ongoing debate about whether ESG disclosures, including those related to climate, should be mandatory. But it's not only the SEC that can make that happen. There have been several bills introduced in Congress, some as recently as 2019, asking for expanded availability of ESG information. One called for an amendment to the Securities Exchange Act of 1934 to require companies to disclose a clear description of the link between ESG metrics and the company's long-term business strategy.[1] In addition, institutional investors are increasingly using their influence to call for public companies to expand their ESG disclosures.

Internationally, listed companies in the UK will be required to report climate-related risks and opportunities by 2022 as a result of the *Task Force on Climate-Related Financial Disclosures* recommendations.

The surge toward increased disclosure is undeniable. In addition to the existing requirements, on March 15, Acting Chair Lee *issued a statement* in which she requested public input from all market participants on the SEC's disclosure rules and guidance as they apply to climate change disclosures, and whether and how they should be modified.

Companies will be well served to evaluate their impact on the climate and the climate's impact on them, and to make transparent disclosures based on that evaluation. And it shouldn't be just about risk; if climate change, or the reaction to climate change results in business opportunities, those should be disclosed, too.

With the heightened focus from a variety of stakeholders, what a company does not say can be as influential as what it does say. There is much that investors and other stakeholders want to know, and much that current SEC rules already require.

[1] H.R. 4329, the ESG Disclosure Simplification Act of 2019

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