SEC on ESG Risk Disclosure – Moving From "If" to "How"

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This is the fifth in our First 100 Days series examining important trends in white collar law and investigations in the early days of the Biden administration. Our previous entry discussed investigations under the new Congress. Up next, a deep dive on liability under the False Claims Act.

As the Biden Administration began to take shape, many observers (including here at Foley Hoag) predicted that the SEC would move toward requiring standardized disclosures by issuers regarding their ESG risks and opportunities. With recent steps and communications, the SEC has removed all doubt. As Acting Chair Alison Herron Lee noted in recent remarks, "it's time to move from the question of 'if' to the more difficult question of 'how' we obtain disclosure on climate" and other ESG issues. In a recent speech to the Center for American Progress, Chair Herron Lee remarked, "no single issue has been more pressing for me than ensuring that the SEC is fully engaged in confronting the risks and opportunities that climate and ESG pose for investors, our financial system, and our economy."

What are "ESG" issues, and why is the SEC (among others) so focused on them?

The E, or environmental, relates to how a company deals with risks and opportunities related to climate, pollution and other environmental factors, and the company's impact on the environment.

The S, or social, concerns a company's values and business relationships, including human capital topics like employee health and safety, as well as diversity and inclusion efforts.

The G, or governance, refers to corporate governance issues, including the composition and diversity of the board of directors, political contributions, and policies to prevent bribery and corruption.

ESG factors are often part of a core risk management strategy for portfolio construction. Current events illustrate why that is so – COVID-19 has brought worker safety considerations front and center; the pandemic has also caused distribution chain breakdowns similar to the disruptive effects of recent climate events; and social justice movements are increasingly powerful agents for change across all aspects of our daily lives. In other words, there is little if any difference perceived by investors between social value and market value. Communications from important market players like Blackrock and State Street have made clear that there is increasing demand by investors for clear and comparable disclosures from issuers on ESG issues.

So, how will the SEC implement an ESG disclosure regime?

The SEC has recently announced three initiatives toward accomplishing this goal.

First, the SEC's Corporate Finance Division Staff will assess what companies are doing to address the guidance the SEC issued in 2010 regarding climate disclosures. Recognizing that much has changed over the last ten years in terms of climate science and the market's reliance on and interest in such data, the SEC will assess current disclosures to determine how the existing guidance should be updated and augmented.

Second, the SEC is soliciting public comment on climate disclosure, including whether the SEC should take an industry-specific approach when it comes to requiring companies to disclose climate risk. And while the public comment solicitation is focused on climate disclosures, the SEC will also be considering the broader ESG framework, including promoting standardized disclosure rules on human capital issues like workforce diversity.

Finally, the SEC has created a Climate and ESG Task Force in the Division of Enforcement. The ESG Task Force's goal will be to develop initiatives proactively identifying ESG-related misconduct. According to the SEC, the Task Force will pursue this goal in two ways. First, it will attempt to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules. Second, the Task Force will also analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.

The ESG Task Force's mandate raises some questions, however. How will the Task Force aggressively pursue misconduct related to ESG disclosures, where SEC leadership has acknowledged that the rules surrounding how companies disclose ESG risks and opportunities are at best, less than clear, and at worst, non-existent in certain respects? Issuers and other market participants are sure to ask this and other questions when responding to Task Force inquiries.

Where there was once debate at the SEC as to whether regulating disclosure of ESG risks were necessary, it appears that debate has been settled. According to Acting Chair Herron Lee, investor demand for clear, consistent and comparable ESG risk disclosures "is not being met by the current voluntary framework."

What are the next steps?

So how will the "how" question get answered? One possibility, which the SEC has acknowledged, is having a dedicated standard setter for ESG – similar to the Financial Accounting Standards Board (FASB) – under SEC oversight to devise an ESG reporting framework. There is international support for such an approach, with the International Financial Reporting Standards Foundation moving forward with work to establish a Sustainability Standards Board (SSB). The SSB may provide a reporting framework that individual jurisdictions, including the U.S., could build upon.

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