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Responding to Climate Change and ESG: A Q&A With Akin Gump's Cynthia M. Mabry & Stacey H. Mitchell

When it comes to ESG issues, companies should remain vigilant for changes from the SEC to their disclosure requirements and prepare for further scrutiny.

BY CYNTHIA M. MABRY AND STACEY H. MITCHELL

Acting Securities and Exchange Commission Chair Allison Herren Lee issued a **statement** Feb. 24 directing the Division of Corporation Finance to "enhance its focus on climate-related disclosure in public company filings." While it's not clear how far or how fast Lee's changes to the **SEC's 2010 interpretative guidance** to public companies regarding existing SEC disclosure requirements as they apply to climate change matters will go, companies should remain vigilant for changes to their disclosure requirements and prepare for further scrutiny.

Texas Lawyer spoke recently about the likelihood of increased complexities and costs associated with changes to the SEC's 2010 interpretive guidance with **Cynthia M. Mabry**, a partner in the corporate practice at Akin Gump Strauss Hauer & Feld and co-leader of its climate change practice; and **Stacey H. Mitchell**, a partner in the environment and natural resources practice at Akin Gump and co-leader of its ESG and climate change practices.

What's going on with the SEC and why is it interested in climate change?

Cynthia M. Mabry and Stacey H. Mitchell: Environmental, social and governance issues, including climate change risk, have increasingly become more important to companies and investors. And as a result, the Securities and Exchange Commission has similarly aligned its priorities with those of the market.

As background, the SEC first addressed disclosure of material environmental issues in the early 1970s and has continued to periodically address the topic since. In 2010, the SEC provided guidance to public companies regarding climate change disclosures (2010 Guidance) and has largely remained silent until this year, when it has released a spate of statements on, and taken several notable actions related to, climate change disclosures and climate risks.

Commissioner Allison Herren Lee, the SEC's acting chair while now-chair Gary Gensler awaited his confirmation, has spearheaded much of the flurry of recent activity. Lee, an outspoken proponent of climate disclosure, **considers** climate change an "urgent" issue that is approaching a "point of no return." Lee has **asserted** that climate risks fall within the SEC's tripartite mission of protecting investors; maintaining fair, orderly and efficient markets; and facilitating capital formation.

Courtesy photos

Cynthia M. Mabry and Stacey H. Mitchell are partners at Akin Gump.

On Feb. 24 Lee issued a **directive** to the SEC's Division of Corporation Finance to assess (through Corp Fin's public filing **review process**) the extent to which public companies are addressing the topics identified in the 2010 Guidance and complying with applicable disclosure rules. Using lessons learned from its review, Corp Fin is expected to begin updating the 2010 Guidance to take into account developments from the last decade. In connection with asking SEC staff to assess its climate disclosure rules, Lee issued a **request for comment** to aid the staff in its evaluation.

A week later, on March 3, the SEC revealed its 2021 examination priorities. While none of the priorities are dedicated exclusively to climate issues, the SEC's accompanying **press release** portends "a greater focus on climate-related risks," acknowledging the "evolving nature of the risks to investors and the markets, including climate and ESG." The SEC also **announced** the creation of a Climate and ESG Task Force in the Division of Enforcement. The task force is developing initiatives to proactively identify ESG-related misconduct, focusing initially on identifying any material gaps or misstatements in issuers' disclosure of climate risks under existing rules. The task force will also analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies. A **Risk Alert** issued by the Division of Examinations last week highlights observations from recent exams of investment advisers, registered investment companies, and private funds offering ESG products and services—similarly highlighting the significance of the commission's focus on ESG disclosures.

Although Corp Fin may issue interpretive guidance or certain exemptive relief on its own that does not contradict commission-level actions, any express rules requiring more specific climate-change disclosures or otherwise convert the commission's principles-based disclosure approach to a prescriptive one would require a new commission vote. Similarly, although enforcement may identify, investigate and bring actions against those whose climate- or ESG-related statements are false or misleading, such actions, without a commission vote on a new rule, would not be based on any new standard. Until then, it will be "business as usual" for enforcement, **according** to Kelly Gibson, the acting deputy director of enforcement and leader of the task force.

What is ESG and why does it matter to the SEC?

ESG refers to the set of environmental, social and governance issues that many companies, investors and other stakeholders address on a voluntary basis through targeted initiatives, programs and disclosure. Within the last two decades, ESG has evolved to take a prominent role in companies' communications with stakeholders. In particular, many companies use ESG programs and a number of disclosure frameworks to showcase corporate responsibility, enhance their value proposition, differentiate their brands, and commit publicly to sustainability targets.

In recent years, there has been a tremendous shift in capital towards ESG and sustainable investment strategies, with ESG risks and metrics now underpinning many traditional investment analyses on investments of all types—a dynamic Lee **refers** to as "ESG integration." Unfortunately, despite attempts by a multitude of international organizations and initiatives to achieve consistency through the development of ESG frameworks and standards, there is currently no universally accepted disclosure system or set of metrics that properly covers all ESG issues for all companies. As Acting Director of Corp Fin John Coates recently **noted**, there remains substantial debate over the precise contents and details of what ESG disclosures might or should encompass. Part of the difficulty is in the fact that ESG is very broad, but at the same time quite specific. The ESG issues companies face can vary significantly based on their industry, geographic location and other factors.

Nevertheless, investors are increasingly asking for information on issues such as human capital, human rights and climate change to help them make informed investment and voting decisions. Such sentiment is evidenced in investor demands for disclosure on these issues, as is increasingly reflected on corporate proxy ballots and companies' publication of sustainability reports. In short, ESG information is quickly becoming material information, and this significance is what puts it squarely within the SEC's scope of regulation. As Lee recently **stated**, the most fundamental role that the SEC must play with respect to climate and ESG is helping to ensure material information gets into the markets in a timely manner.

Are more regulatory requirements mandating ESG disclosures warranted?

It depends on who you ask! **Studies** indicate that many investors use ESG information to evaluate long-term value and promote social goals, monitor companies' risk management strategies, inform shareholder votes, create targeted funds, apply pressure to companies to improve performance and, in some cases, guide divestment decisions. However, there is not currently a consensus on whether ESG disclosure requirements should be mandatory or voluntary.

Critics of ESG disclosure requirements point to the added costs and legal risks related to a mandate. At a basic level, some critics—including Commissioner Hester Peirce—**believe** that ESG metrics prioritizing stakeholder interests would "mark a departure from" the SEC's current investor-oriented approach and expand the commission's jurisdictional reach. They also **assert** that prescriptive rules may reduce the flexibility companies enjoy under the current principles-based disclosure approach, potentially leading to less transparency at the expense of stakeholders' actual needs. For the reasons Acting Director Coates recently **noted**, a one-size-fits-all approach may not meet the needs of a particular industry or company, and could impose disproportionate costs on smaller entities.

Proponents of ESG disclosure requirements point to the costs of not having ESG disclosure requirements. Citing the increased investor demand for ESG information, they argue that companies face higher costs in responding to such demands because there is no consensus ESG disclosure system. With such a void, companies continue to face numerous, conflicting and frequently redundant requests for different information about the same topics. In addition to financial costs, proponents note that inadequate disclosure of ESG issues subjects companies to legal risks under securities and consumer protection laws. Although the SEC has not pursued high-profile ESG-related enforcement actions to date, recent developments (e.g., the **establishment** of the Climate and ESG Task Force) suggest this might change in the future.

The establishment of a disclosure system for ESG issues need not mean that a company must respond to every requirement. As Acting Director Coates recently **noted**, the SEC's existing disclosure regime is fairly nuanced. It permits significant differences in how companies respond to a variety of "mandatory" requirements, including in many cases disclosing items if and only if they are material. The SEC's disclosure system also contains "comply or explain" requirements where the ability to explain makes the requirement less than rigidly mandatory and, for some companies, potentially more informative. There is no reason an ESG disclosure system cannot be similarly nuanced.

What changes will be made to the 2010 guidance or existing regulations?

If history is any indication, any changes to the 2010 climate change guidance (2010 Guidance) or existing regulations will likely come from Lee's **request for comment**. Seeking public input from investors, registrants and other market participants on climate change disclosure, she posed over a dozen questions for consideration. These include requests for input on the appropriate approach to regulating climate disclosure, the use of third-party reporting frameworks, the degree to which registrants can measure climate risk, how the commission should enforce disclosures and whether the SEC should institute a broader ESG disclosure framework, among others.

Any updates to the 2010 Guidance are likely to reflect investors' demand for more quantifiable ESG data, which has become possible as reporting companies have developed robust systems for measuring and responding to climate and ESG risks and opportunities. Such guidance will also likely provide more direction for companies struggling to provide useful disclosures, given that the initial guidance only outlined certain ways in which climate change may trigger disclosure obligations under the SEC's existing disclosure framework.

While a radically progressive departure from its principles-based disclosure approach is unlikely, a Democratic-controlled SEC chaired by Gensler may do more than merely issue interpretive guidance. Democratic commissioners Lee and Caroline Crenshaw **decried** the recent updates to Regulation S-K for the heavy reliance on a principles-based disclosure approach and the fact that such amendments largely omitted ESG disclosure requirements. If Lee's public **statements** are any indication, any new ESG disclosure requirements will likely include additional disclosures related to climate change, workforce and board diversity, inclusion and equity and/or corporate political spending. Separate from and in addition to any of its own ESG disclosure initiatives, the SEC might collaborate internationally on a unified, global ESG framework, similar to the Federal Reserve's recent **decision** to join other central banks to improve global management of climate risks.

What actions can executives and officers of companies take to ensure they will be in compliance to changes to the 2010 guidance?

A great starting point would be to review existing climate disclosures, whether in filed SEC reports or published sustainability reports, for any gaps or misstatements under existing rules. Climate disclosures in SEC reports, particularly those in the business section or risk factors of Form 10-K, are often carried forward quarter after quarter, without a careful review for updates regarding legislative action, judicial proceedings, quantitative thresholds, changes in circumstance or general applicability. In connection with checking for necessary updates, executives should also check for accuracy and work closely with outside counsel to avoid making false or misleading statements.

Further, review past statements and goals on climate change and other ESG metrics and compare those to what the company is doing now. Be mindful not to overstate a company's commitment to sustainability or positive contributions to the environment—and **be especially wary** of greenwashing, which is the process of conveying a false impression or providing misleading information about environmental friendliness of a company's products or business. In addition, manufacturing, energy and transportation-related businesses should avoid understating quantitative climate-related statistics (e.g., emissions).

In connection with and in support of the above efforts, prudent executives should orient their governance functions around the latest climate science, risks, opportunities and regulatory developments. To address these issues, boards should **assign** responsibility for climate issues to committee chairs or independent directors and/or engage outside experts to advise and incorporate climate into material risk and opportunity assessments. Companies should also monitor (or engage outside advisers to monitor) developments from Congress and federal agencies to understand how future regulatory changes might affect their business and present new, material climate issues.

We would also encourage company executives to ensure the development, operation and maintenance of robust internal reporting systems to gather and process data. This is particularly important with respect to climate and ESG disclosure, which often requires tracking more complicated metrics than operational or financial disclosure. Companies in industries with more complex environmental footprints may consider engaging substantive experts, alongside the internal controls team, to develop an effective tracking system and ensure that they are considering all possible bases for disclosure. Of course, companies should consider what level of disclosure makes sense, given their industry and investors' needs.

For executives whose companies have not developed climate or ESG-related governance functions or internal reporting systems, we would suggest reviewing well-recognized frameworks—like the Task Force on Climate-Related Financial Disclosures (**TCFD**), Sustainability Accounting Standards Board (**SASB**) and Global Reporting Initiative (**GRI**). Another useful reporting standard for climate-specific issues is **CDP**, formerly the Carbon Disclosure Project. CDP has decades of specialized experience in climate disclosure, having produced a global environmental disclosure system used by nearly 10 thousand investors and companies and a thousand more governmental entities. By familiarizing themselves with such resources, even if just one or two, executives can identify issues most likely to be material to their business and issue appropriate disclosures.

Last, but not least, it is important to monitor peers and other similarly situated companies to stay abreast of developments in the disclosure "market." Insufficient or unwarranted disclosures that deviate from the rest of the industry without adequate justification could attract attention from the SEC or investors—and not likely in a good way.

What questions should executives and officers be asking about the changes?

Rather than asking questions about forthcoming changes to climate change disclosures, company executives and officers might consider submitting **answers** (to Lee's **request for comment**)! If company executives and officers are intending to self-assess and prepare for possible changes, rather than effectuate policy, they might consider the following questions, among others:

1. Do our existing climate disclosures in our filed SEC reports sufficiently comply with the existing guidance?
2. What changes will we have to make to our existing data collection, processing and analysis to prepare for more stringent climate disclosure requirements?
3. Which climate issues or disclosures have we overlooked? For example, although we adequately collect information and report on our greenhouse gas emissions, have we considered the operational and/or disclosure effects of the United States rejoining the Paris Agreement in February?
4. Are we already doing everything we need to do? If so, what steps can we take to continually evaluate and make necessary adjustments to our overall climate strategy?

Why should anyone be capped as a stakeholder when they are not a shareholder?

Virtually every company, given the choice, would want to be known for being a good corporate citizen. Operating with all stakeholders in mind can keep employees happy, avoid enforcement actions, attract customers and talent, secure capital, minimize disruptive shareholder proposals or suits, build more effective relationships with vendors and suppliers, and appropriately address risks in an increasingly complicated and polarized world. Unfortunately, doing what one wants often conflicts with doing what one must.

While some companies continue to hold on to the self-imposed mandate to maximize only shareholder value, the practical reality is that most companies consider non-shareholder stakeholders when conducting their operations. There is also increasing evidence that by doing so they are in turn producing greater shareholder value. For many medium and large businesses, their global footprint means that their operations impact innumerable people and companies and have a measurable impact on the environment. While the choices a board of directors makes will directly affect a company's workforce, suppliers, vendors and competitors, such choices will indirectly, but often equally, affect non-shareholder stakeholders in the physical areas where they operate. For this reason, companies have incentives to be a good neighbor.

Considering stakeholders when conducting business is **key** to long-term, sustainable performance and will help companies operate more efficiently over time. Because regulatory burdens related to climate and ESG issues are likely to increase over time, such consideration also prepares companies for the future.

Do you have any other observations you would like to share?

Given recent developments, much attention is on the SEC right now, and rightly so. However, we urge your readers not to neglect what other regulators are doing in the climate and ESG spaces. The Biden-Harris Administration has stated that it is taking a whole-of-government approach to acting on climate change. And federal agencies are beginning to take action. The Department of Labor is currently reconsidering a Trump-era **rule** that limits the ability of retirement plan fiduciaries to base investment decisions on ESG considerations. Both the **Federal Reserve** and **Commodity Future Trading Commission** have launched climate-focused initiatives. And Treasury Secretary Janet Yellen created a "Climate Hub" and named John Morton as her climate counselor. This followed commitments to take steps to address climate change, including increasing the availability of information on climate-related financial risks, encouraging financial institutions to meet the Paris Agreement's goals, and bolstering the use of climate finance tools.

There is also ample space for state regulation. Some states, like **California**, already require corporate boards to include minority individuals or force companies to issue disclosures on board diversity. **New Jersey** and **Michigan** have proposed similar bills. Additionally, Illinois' **Sustainable Investing Act** requires publicly managed funds to integrate sustainability factors into investment decisions, portfolio construction and due diligence. With respect to climate disclosure, a recently proposed California **bill** would require large companies to publish emission targets and disclose both direct and indirect emissions in annual reports.

Meanwhile, foreign regulators have a head start on the United States. Effective last month, the European Union's **Sustainable Finance Disclosure Regulation** requires some funds, insurance providers, pensions and financial advisers to consider sustainability risks. Earlier this year, the United Kingdom Conduct Authority **mandated** climate-related financial disclosure beginning as early as Jan. 1, in accordance with TCFD recommendations. These are just two of **many** climate and ESG regulations in place throughout the world.

Finally, and perhaps most importantly, do not lose sight of the big picture. While integrating climate and ESG strategies into a company's overall strategy and day-to-day operations can be both complicated and costly, an effective ESG program with appropriately tailored disclosure mechanisms generally **drives** value. For most, it just makes good business sense.