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# Expect New SEC Leadership To Require More ESG Reporting

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Public companies should expect more environmental, social and governance-related disclosure requirements, focusing initially on climate risk.[1]

An element of President-elect Joe Biden's platform has been "[r]equiring public companies to disclose climate risks and the greenhouse gas emissions in their operations and supply chains."[2] More recently, Biden has made clear that climate risks will be a financial regulatory priority when introducing his key economic and financial advisers.[3]

Janet Yellen, his pick for secretary of the U.S. Department of the Treasury, promised to advance "investments that will create jobs and address the tremendous challenge of climate change." While a new U.S. Securities and Exchange Commission chairman has not yet been named, he or she is almost certain to emphasize the new administration's priorities.

To be sure, outgoing SEC Chairman Jay Clayton did not voice opposition to measures to address climate risk or other elements of ESG, but like many of his predecessors he has been reluctant to require broad disclosure on the topic, noting skepticism that a uniform set of disclosure requirements could be established that would be relevant to all industries and companies.[4]

Under his leadership, the agency did adopt modest new disclosure requirements relating to human capital, a key component of ESG that refers to a company's workforce. Because they are principles based, the new rules do not call for uniform, comparable disclosures among public companies on the subject.[5]

Last May, the SEC's Investor Advisory Committee approved a recommendation that the SEC adopt an integrated disclosure regime that provides uniform ESG disclosures among public companies to permit investors to compare one company to another, and to provide a uniform framework for related disclosures for public companies.[6]

Under the new administration, the SEC is likely to accommodate the Investor Advisory Committee with new disclosure rules covering public companies' risks and initiatives on climate change, as well as potentially other elements of ESG, although such rules may not go so far as to provide the uniform disclosure framework that the committee recommended.

**Disclosure Rules on Climate Risks and Activities**

In proposing new disclosure requirements specifically related to climate risk, the SEC would be writing on a relatively clean slate. Currently, Item 103 of Regulation S-K requires disclosure of material civil or governmental proceedings involving laws whose primary purpose is environmental protection, and the SEC has recently adopted rules at the direction of Congress requiring disclosure related to payments made in connection with resource extraction.

Item 101 of Regulation S-K, furthermore, requires disclosure of the material effects of compliance with government regulations, including environmental regulations. Foreign private issuers must describe any environmental issues that may affect their utilization of their physical assets.

Climate risk disclosure could also be required under current rules on management's discussion and analysis. Under the management's discussion and analysis requirements, for example, if the risk represents a known trend or uncertainty that the company reasonably expects will have a material impact on the company's results of operations or capital resources, additional disclosure would be required.

An example might be the impact of expenditures to combat rising sea levels for a company that owns and operates shoreline properties. Along the same lines, climate risk could pose a material risk to the company, in which case it would be required disclosure of risk factors under Item 105 of Regulation S-K.In 2010, the SEC provided guidance for considering climate risk in complying with these rules.[7] The SEC, however, could go much further, and adopt rules that expressly require disclosure on the company's operations and supply chain insofar as they involve activities associated with climate change, and the potential future material impact on the company of governmental and other responses to climate change.

While the SEC may not adopt the comprehensive disclosure framework recommended by the Investor Advisory Committee, it could require companies to choose from among publicly available metrics to follow as a basis for the disclosure. Organizations such as the Sustainability Accounting Standards Board, the Global Reporting Initiative [8] and the Task Force on Climate-related Financial Disclosures publish detailed, industry-specific metrics, and large institutional investors have pressed companies to follow and disclose information based on them.

While any new additional disclosure requirements adopted by the SEC are likely to apply to quarterly reports on Form 10-Q and annual reports on Form 10-K, or 20-F for foreign private issuers, the SEC could also expand the disclosure in proxy statements covering the election of directors to address board oversight of climate risks and related disclosure.

**Other ESG Disclosure Rules**

If the SEC proposes new rules on ESG beyond climate risk, we believe that such rules are most likely to fall under the governance prong of ESG, rather than the social prong. The agency has traditionally shied away from social policy topics, unless specifically mandated by Congress. While corporate governance is primarily the territory of state corporate law, the SEC in many respects shares that subject with the states, such as for example SEC rules governing proxy voting at shareholder meetings and the SEC's rules on board committee independence.

For example, while the SEC has no current rules compelling disclosure of board diversity, it could require companies to disclose the diverse characteristics of board members.[9] New rules addressing board diversity could also require more detail on how the company considers diversity in its board nomination process.

Nasdaq Inc. has recently proposed a new listing rule that would require at least two diverse directors on boards of most companies listed on Nasdaq, or disclosure explaining why the company does not have such directors. The Nasdaq proposal follows legislation adopted or proposed by several states requiring minimum levels of board diversity or disclosure.

As noted above, the SEC might also amend its proxy rules to require further disclosure of board oversight of ESG considerations relevant to a company's operations and supply chains. In 2010, the agency took such an approach when it adopted rules requiring disclosure of the board's role in the risk oversight of the company.

**SEC Interpretive Guidance and Staff Comment Letters**

Even before it adopts any new disclosure rules, the SEC or its staff could issue additional interpretive guidance that warns companies to consider ESG risks when complying with existing disclosure requirements, such as by updating its climate change release. Such guidance need not follow the lengthy public comment procedures that apply to the proposal and adoption of new rules.

Most likely, the SEC or its staff could draft new guidance in a more prescriptive manner, such as by addressing the types of disclosures that it expects companies to consider if they operate in industries that are most commonly associated with climate change.

An important question is whether the SEC will consider providing guidance on the concept of materiality as it relates to ESG. The current definition of materiality has been fashioned by the courts over decades. The classic definition of materiality is financial, and focuses on whether the information would be considered important to a reasonable investor in making an investment decision.

In TSC Industries Inc. vs. Northway Inc.,[10] the U.S. Supreme Court stated that "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

The SEC could provide guidance on how various elements of climate risk could be material to public companies, but such an effort would be challenging and could — intentionally or unintentionally — signal a departure from either market practice or the SEC's prior guidance on materiality.

For example, companies often focus primarily, although not exclusively, on a 12-month time frame in evaluating many materiality questions, but the timing of the impact of some climate risks such as global warming could be unpredictable and may not neatly fall within specific annual or quarterly periods, so any related SEC guidance may have to address the appropriate time frame.

The Investor Advisory Committee in its recommendation on ESG did not suggest guidance on materiality, and the SEC likely will steer away from it as well.

Finally, we expect the SEC staff to look closely at ESG disclosure when it reviews periodic SEC filings in the coming year and beyond. Very often, following the issuance of disclosure guidance, the SEC staff will focus on how well companies have applied the guidance in their filings.

The staff took such an approach when it provided disclosure guidance to companies in considering public disclosure of the impacts of COVID-19, followed by staff comments on related disclosure in SEC filings.

**Institutional Investors and Proxy Advisers**

While we expect regulatory changes will have additional impact on the ESG disclosure that companies provide in the coming years, institutional investors have had a significant impact on companies ESG activities and public disclosure. A small number of the largest institutional investors have endorsed ESG reporting frameworks, adopted voting guidelines with respect to ESG disclosure and initiatives, and have engaged in more active engagement with their portfolio companies on these issues.

Proxy advisers Institutional Shareholder Services Inc. and Glass Lewis & Co. LLC this year have each beefed up their voting guidelines on board oversight of ESG matters. For example, Glass Lewis recently announced that for the 2022 proxy season it will recommend voting against the chair of the governance committee for an S&P 500 company that fails to provide express disclosure of the board's oversight role for these issues.

**What Public Companies Should Do Now**

While only time will tell what actions the SEC take, we believe that it is a near certainty that there will be new rules and guidance on climate risks and potentially other areas of ESG.

While many public companies have already engaged with ESG in varying degrees, they should consider whether and how new disclosure rules might impact the timing and the substance of their plans to address ESG. Companies that have not yet engaged meaningfully with ESG should consider starting a process to educate management and the board on developments to date, as well as the likelihood of additional disclosure requirements.

[1] ESG is a broad term that generally refers to environmental, social and corporate governance concerns as they apply to companies and their operations.

[2] See President-Elect's climate plan at https://joebiden.com/climate-plan/.

[3] For Biden's Economic Team, an Early Focus on Climate, New York Times (Dec. 11, 2020)

[4] See, e.g., Chairman Clayton's remarks to the Investor Advisory Committee on December 13, 2018, available at https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-meeting-121318, and om November 2019, available at https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-110719.

[5] See Regulation S-K Item 101(c)(2)(ii), 17 CFR 229.101(c)(2)(ii).

[6] On May 21, 2020, the Investor Advisory Committee approved a recommendation of its subcommittee entitled Recommendation from the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to ESG Disclosure (May 14, 2020), available at https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-of-the-investor-as-owner-subcommittee-on-esg-disclosure.pdf.

[7] Commission Guidance Regarding Disclosure Related to Climate Change (Release No. 339106, February 2, 2020).

[8] The SEC noted GRI's framework in particular in the Climate Change Release.

[9] The SEC staff has issued an informal interpretation stating that it "expects" that relevant self-identified diversity characteristics of board members would be disclosed if the director consents to such disclosure and the company has disclosed that it uses such diversity characteristics in considering its board nominees.

[10] 426 U.S. 438 (1976).

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