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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

ESG Agenda May Lead The SEC Down Long, Litigious Path

By **Al Barbarino**

Law360 (March 12, 2021, 2:21 PM EST) -- The U.S. Securities and Exchange Commission has been talking tough when it comes to companies' ESG disclosures, but developing new regulations to address the issue is a likely yearslong task, while any enforcement actions taken in the interim could bring a wave of litigation that puts the agency at the mercy of the courts, experts told Law360.

Acting SEC chief Allison Herren Lee, who is scheduled to give a speech Monday about "meeting investor demand" for so-called environmental, social and governance information, has put her weight behind the agency's disclosure efforts.

Lee asked the Division of Corporation Finance last month to review the SEC's 2010 climate change disclosure guidance, and days later called for a new "global" climate-related disclosure framework.

"It demands a global solution," Lee said at a March 1 event. "And we're committed to working toward that. We need to better analyze and understand the risks that climate change presents to financial markets, including potentially systemic risks."

Meanwhile, President Joe Biden's nominee to be the next SEC chair, Gary Gensler, said at his confirmation hearing the following day that "investors really want to see climate risk disclosures," leaving the door open for a new framework.

"I don't think Gensler wants to spend his time rehashing a document that's over 10 years old, and I think he probably wants to carve a new path," said Scott Kimpel, a partner at Hunton Andrews Kurth LLP and former SEC counsel.

Under the Administrative Procedure Act, or APA, the SEC undertakes an already lengthy rulemaking process to create new rules, including a required public comment period.

But with an issue as ripe for controversy as ESG-related disclosures — and potential dissenting stances already signaled by two Republican SEC commissioners — any new rulemaking process focused on ESG disclosures is likely to stretch for years and draw thousands of comments, Kimpel said.

"That's a tall order," said Kimpel. "Disclosure issues may be a sweet spot for the SEC. But climate change, and all the different issues surrounding it, certainly is not."

"Even when the SEC is really humming, really flying, and it's an issue where there's a great deal of consensus, it takes about a year to go from the proposal to adoption of a rule," Kimpel added. "But there's not great consistency or consensus around this issue."

Lee herself called the undertaking one of "staggering complexity," noting that it would have to take into account risk modeling "over a span of different potential outcomes."

"That's complicated. But of course, we can't afford to just throw up our hands," Lee said.

The SEC's Potential Next Steps

Lee noted that the corporation finance division will use insights from its review of the 2010 guidance "to begin updating" it.

John Coates, the unit's acting director and a member of the SEC investment advisory committee that urged the agency last year to establish ESG disclosure policies, reiterated Thursday that the commission "should help lead the creation of an effective disclosure system for ESG."

In addition, the SEC announced the creation of a new ESG enforcement task force to clamp down on potential disclosure violations and other misconduct.

David M. Lynn, a Morrison Foerster LLP partner and ex-chief counsel in the SEC's corporation finance unit, said the task force could allow the agency to "fill the gap" before any new rulemaking or guidance is written.

"By having staff dedicated to looking more closely at the disclosures, they can effectively figure out the state of disclosure," said Lynn. "This also generates information that they can use for subsequent rulemaking or additional guidance."

Operating through existing anti-fraud laws, the task force could ramp up enforcement actions against companies, but that could also bring a wave of litigation, added David L. Kornblau, chair of Covington & Burling LLP's securities enforcement group and ex-SEC chief litigation counsel.

"Until the agency adopts new climate disclosure regulations, for enforcement purposes it will need to rely on its general anti-fraud authority," Kornblau said. "So they would be looking for disclosures by public companies that they think either misstated or omitted material facts relating to climate risk."

In order to "be able to declare [the task force] a success," the SEC could bring cases that are "more marginal, more aggressive" while potentially demanding higher penalties from companies, which could incentivize the companies to litigate rather than settle, Kornblau added.

"If they're litigated, then the courts are going to have the final say rather than the SEC," he said.

Looking ahead to potential new ESG disclosure rulemaking, a key decision lies ahead for the SEC: whether to chart its own course or to weave in existing global standards, such as the Sustainability Accounting Standards Board, which was founded in 2011 with the aim of developing standards for use in SEC filings.

"The SEC is going to have to think about whether it makes the most sense to start from scratch or adopt

an already existing disclosure framework," said Christina M. Thomas, a partner in Mayer Brown LLP's capital markets practice, whose focus includes SEC disclosure requirements, and ESG matters.

On one hand, the SEC may want to "benefit from all of the work that's gone into existing frameworks and all of the knowledge that those are built on," Thomas noted. Yet the SEC could be compelled to "adopt its own standards over which it would have unilateral control," she added.

What Can Companies Do to Prepare

The SEC's existing 2010 climate disclosures guidance — now under review by the corporation finance unit — mapped out a series of largely principles-based rules for companies to address climate risks.

For instance, the guidance asked companies to assess climate-related disclosures based on such things as climate-related international accords and treaties; a company's legal, technological, political and scientific developments; and climate-related laws and regulations.

A review of the guidance is a starting point for companies looking to stay out of the SEC's crosshairs, Thomas said.

"Everyone has been given a heads up that the staff is going to be focused on this, so everyone would do well to reread that guidance," she said. "They should compare it to the disclosures they are providing, and see if they need to make any revisions in response to that."

"In addition to following SEC disclosure guidance, companies are listening to what their investors want," she added, noting that companies in industries such as mining, oil and gas, and property and casualty insurance could be a focus of staff attention.

Experts agreed that companies are largely on top of the existing guidance already.

"This isn't just coming out of the blue," said Lynn of Morrison Foerster. "People have been talking about this topic for at least a decade and have the infrastructure in place to produce the information."

However, firms may want to start considering how they will incorporate existing disclosures — such as those in proxy statements or sustainability reports on their websites — into their 10-K and 10-Q reports if the SEC makes that a requirement down the road, Lynn said.

Ultimately, following the recent onslaught of SEC actions putting regulated firms on notice, companies are likely to welcome any future rulemaking or guidance that can add clarity to the existing ESG disclosure framework, attorneys said.

"In general, companies greatly prefer clear guidance, whether it's in the form of a new rule or guidance at the staff level, than being blindsided by enforcement activity," Kornblau said.

--Editing by Philip Shea.