Harvard Law School Forum on Corporate Governance

SEC Comments on Climate Change Disclosure

Posted by Jina Choi and David M. Lynn, Morrison & Foerster LLP, on Sunday, October 17, 2021

Tags: Climate change, Environmental disclosure, ESG, SEC, SEC rulemaking, Securities regulation, Sustainability
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Editor's Note: Jina Choi and **David M. Lynn** are partners at Morrison & Foerster LLP. This post is based on their Morrison & Foerster memorandum. Related research from the Program on Corporate Governance includes **The Illusory Promise of Stakeholder Governance** (discussed on the Forum **here**) and **Will Corporations Deliver to All Stakeholders?**, both by Lucian A. Bebchuk and Roberto Tallarita; **For Whom Corporate Leaders Bargain** by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum **here**); and **Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock** by Leo E. Strine, Jr. (discussed on the Forum **here**).

The Division of Corporation Finance of the U.S. Securities and Exchange Commission recently published a sample letter to companies providing illustrative comments that the Division of Corporation Finance may issue to companies regarding their climate-related disclosure, or the absence of climate-related disclosure [1] (the "Sample Letter").

This action is the latest in a series of developments demonstrating the SEC's focus on climate disclosure by public companies.

- The SEC continues to focus on and spotlight climate change and ESG-related disclosure obligations under the federal securities laws.
- The SEC may be working to update its 2010 guidance on climate change disclosure and the staff of the Division of Corporation Finance has sent out letters to public companies providing comments on climate-related disclosure or the lack of such disclosure in SEC reports.
- The SEC set forth a Sample Letter with illustrative comments regarding Risk Factor and MD&A disclosures.
- Companies should also consider recent guidance on how climate-related risks may need to be addressed in financial statements.
- The SEC's Enforcement Division has set up an ESG Task Force which is focusing on any material gaps or misstatements in companies' disclosure of climate risks under existing rules.

Background

In February 2021, the SEC's then-Acting Chair Allison Herren Lee directed the Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings. [2] As part of its enhanced focus in this area, the staff of the Division of Corporation Finance (the "Staff") has been reviewing the extent to which public companies address the topics identified in the SEC's 2010 guidance on climate change disclosure (the "2010 Guidance"), [3] assessing compliance with disclosure obligations under the federal securities laws, engaging with public companies on these issues, and learning how the market is currently managing climate-related risks. The February 2021 announcement by the then-Acting Chair noted that the Staff will use insights from this work to update the 2010 Guidance.

In the 2010 Guidance, the SEC identified Regulation S-K Item 101 (Description of Business), Item 103 (Legal Proceedings), Item 105 (Risk Factors), and Item 303 (Management's Discussion and Analysis of Financial Condition and Results of Operations) as items that may potentially require climate change disclosures. The SEC also noted in the guidance that, in addition to the various Regulation S-K line-item requirements, companies "must also consider any financial statement implications of climate change issues in accordance with applicable accounting standards," including ASC 450 under U.S. GAAP. Disclosure matters discussed in the 2010 Guidance include:

- The impact of pending or existing climate change-related legislation, regulations, and international accords;
- The indirect consequences of regulation or business trends; and
- The physical impacts of climate change.

In the Sample Letter, the Staff notes that companies also must disclose, in addition to the information expressly required by Commission regulation, "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.” [4]

The Sample Letter Comments

The illustrative comments that are included in the Sample Letter are consistent with comments that public companies have been receiving in recent weeks from the Division of Corporation Finance on disclosure in their most recently filed Annual Reports on Form 10-K. The Sample Letter indicates that the sample comments do not constitute an exhaustive list of the issues that companies should consider, and “[a]ny comments issued would be appropriately tailored to the specific company and industry, and would take into consideration the disclosure that a company has provided in Commission filings.”

The comments included in the Sample Letter are as follows:

General

1. We note that you provided more expansive disclosure in your corporate social responsibility report (CSR report) than you provided in your SEC filings. Please advise us what consideration you gave to providing the same type of climate-related disclosure in your SEC filings as you provided in your CSR report.

Risk Factors

2. Disclose the material effects of transition risks related to climate change that may affect your business, financial condition, and results of operations, such as policy and regulatory changes that could impose operational and compliance burdens, market trends that may alter business opportunities, credit risks, or technological changes.
3. Disclose any material litigation risks related to climate change and explain the potential impact to the company.

Management’s Discussion and Analysis of Financial Condition and Results of Operations

4. There have been significant developments in federal and state legislation and regulation and international accords regarding climate change that you have not discussed in your filing. Please revise your disclosure to identify material pending or existing climate change-related legislation, regulations, and international accords and describe any material effect on your business, financial condition, and results of operations.
5. Revise your disclosure to identify any material past and/or future capital expenditures for climate-related projects. If material, please quantify these expenditures.
6. To the extent material, discuss the indirect consequences of climate-related regulation or business trends, such as the following:
    - decreased demand for goods or services that produce significant greenhouse gas emissions or are related to carbon-based energy sources;
    - increased demand for goods that result in lower emissions than competing products;
    - increased competition to develop innovative new products that result in lower emissions;
    - increased demand for generation and transmission of energy from alternative energy sources; and
    - any anticipated reputational risks resulting from operations or products that produce material greenhouse gas emissions.
7. If material, discuss the physical effects of climate change on your operations and results. This disclosure may include the following:
    - severity of weather, such as floods, hurricanes, sea levels, arability of farmland, extreme fires, and water availability and quality;
    - quantification of material weather-related damages to your property or operations;
    - potential for indirect weather-related impacts that have affected or may affect your major customers or suppliers;
    - decreased agricultural production capacity in areas affected by drought or other weather-related changes; and
    - any weather-related impacts on the cost or availability of insurance.
8. Quantify any material increased compliance costs related to climate change.
9. If material, provide disclosure about your purchase or sale of carbon credits or offsets and any material effects on your business, financial condition, and results of operations.

Financial Statement Considerations

The Sample Letter does not include illustrative comments on disclosure included in financial statements or financial accounting matters, but companies should consider recent guidance on how climate-related risks may need to be addressed in financial statements.

In May 2021, Lindsay McCord, the Chief Accountant of the Division of Corporation Finance, warned at the Baruch College spring financial reporting conference that the Staff is scrutinizing how companies account for climate-related risks and impacts based on current accounting standards, such as standards for asset retirement, environmental obligations, and loss contingencies. It should be noted that earlier this year, the Financial Accounting Standards Board ("FASB") published a staff educational paper regarding the intersection of environmental, social, and governance ("ESG") matters and financial accounting standards, addressing both accounting issues and management disclosures. [5] The educational paper provides examples of how an entity may consider the direct or indirect effects of material environmental matters when applying current U.S. GAAP, including:

- Subtopic 205-40, Presentation of Financial Statements—Going Concern;
- Topic 275, Risks and Uncertainties;
- Topic 330, Inventory;
- Subtopic 350-20, Intangibles—Goodwill and Other—Goodwill and Subtopic 350-30, Intangibles—Goodwill and Other—General Intangibles Other Than Goodwill;
- Topic 360, Property, Plant, and Equipment;
- Subtopic 410-20, Asset Retirement and Environmental Obligations—Asset Retirement Obligations; Subtopic 410-30, Asset Retirement and Environmental Obligations—Environmental Obligations; Subtopic 450-20, Contingencies—Loss Contingencies; and Subtopic 450-30, Contingencies—Gain Contingencies;
- Topic 740, Income Taxes;
- Topic 820, Fair Value Measurement; and
- Various industry guidance in the 900 Topics.

SEC Division of Enforcement Climate and ESG Task Force

In March 2021, the SEC announced the creation of a Climate and ESG Task Force (the "Task Force") in the Division of Enforcement. [6] The SEC indicated that the Task Force is developing initiatives to proactively identify ESG-related misconduct. The Task Force's initial focus is to identify any material gaps or misstatements in companies' disclosure of climate risks under existing rules. The Task Force works closely with other SEC divisions and offices, including the Division of Corporation Finance. Companies that receive comment letters regarding climate change disclosure from the Division of Corporation Finance should recognize that their responses may be shared with the Task Force.

While it may take time for investigations generated by the Task Force to come to a conclusion, senior leadership in the Enforcement Division has pointed to the September 2020 action against Fiat Chrysler Automobiles ("FCA") as the type of case the public may expect from the Task Force. [7] In that case, the SEC charged the London-based public company which sold cars through its Michigan-based subsidiary with misleading disclosures about an internal audit of its emissions controls systems. [8]

In the wake of the VW "Dieselgate" scandal in which VW installed a "defeat device" on diesel vehicles in order to pass U.S. emissions tests, FCA and other car manufacturers began receiving inquiries about their "EcoDiesel" engines and the Environmental Protection Agency (the "EPA") and the California Air Resource Board (CARB) announced that they would be testing diesel vehicles for "the purposes of investigating a potential defeat device." FCA launched its own internal audit to determine whether any of its vehicles contained VW-like defeat devices. According to the SEC's Order, the audit was focused on whether any of the software in the engines contained code or was calibrated to detect if the vehicles were undergoing emissions testing like the defeat devices at VW. Also, the SEC's Order alleged the internal audit was not a comprehensive review to check for defeat devices generally or to ensure compliance with U.S. emissions regulations.

The SEC found certain statements made by FCA in early 2016, including one that claimed that the "audit revealed that all current production vehicle calibrations are compliant with applicable regulations" to be misleading, because FCA did not sufficiently disclose that the internal audit had a limited scope and did not cover or address some of the issues the EPA had been raising with FCA. In fact, in 2017, the EPA issued a notice of violation to FCA and the Department of Justice filed a complaint against FCA and certain of its subsidiaries for violations of the Clean Air Act. To settle the SEC's enforcement action, FCA paid a $9.5 million penalty for filing misleading statements or reports.

Climate Change Disclosure Rulemaking Efforts

In March 2021, then-Acting SEC Chair Lee asked the Staff to evaluate the SEC's disclosure rules "with an eye toward facilitating the disclosure of consistent, comparable, and reliable information on climate change." [9] To facilitate the Staff's assessment, Lee requested public comment on questions that would be useful to consider as part of the evaluation. Lee also solicited comments generally as to how the SEC can best regulate climate change disclosures. The SEC has received over 400 comment letters in response to this request.

Also in March 2021, John Coates, the then-Acting Director of the Division of Corporation Finance and now the SEC's General Counsel, stated his view that the SEC "should help lead the creation of an effective ESG disclosure system so companies can provide investors with information they need in a cost-effective manner." [10] Coates also advocated for a single global ESG disclosure framework.

In June 2021, SEC Chair Gary Gensler indicated that he has asked the Staff to put together recommendations for mandatory company disclosures on climate risk. [11] He has specifically asked the Staff for recommendations for considerations around governance, strategy, and risk management related to climate risk. In addition, Gensler noted that the Staff is looking into a range of specific metrics, such as greenhouse gas emissions, to determine which are most relevant to investors. Gensler also asked the Staff to consider potential requirements for companies that have made forward-looking climate commitments, or that have significant operations in jurisdictions with national requirements to achieve specific, climate-related targets.

What's Next

We expect that the SEC will propose rules addressing climate change disclosure in the near term. The Enforcement Division's Task Force will continue to develop initiatives and investigations related to climate and ESG-related disclosure. Companies are now in the process of responding to comments that they have received from the Division of Corporation Finance on their climate-related disclosure, or the absence of such disclosure, and we expect that process to continue to play out through the Fall of 2021. In the meantime, public companies should continue to focus on the information that they include in their SEC filings and in other communications regarding climate change risks and carefully consider the applicability of existing SEC and Staff guidance to their disclosures.

Endnotes

[1] *Sample Letter to Companies Regarding Climate Change Disclosures*, available at **https://www.sec.gov/corpfin/sample-letter-climate-change-disclosures**.
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[2] *Statement on the Review of Climate-Related Disclosure* (Feb. 24, 2021), available at **https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure**.
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[3] *Commission Guidance Regarding Disclosure Related to Climate Change*, Release No. 33-9106 (Feb. 2, 2010), available at
https://www.sec.gov/rules/interp/2010/33-9106.pdf.
(go back)

[4] Rule 408 under the Securities Act of 1933 and Rule 12b-20 under the Securities Exchange Act of 1934.
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[5] FASB Staff Educational Paper, *Intersection of Environmental, Social, and Governance Matters with Financial Accounting Standards* (Mar. 19, 2021), available at **https://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176176379917**.
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[6] *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues* (Mar. 4, 2021), available at
https://www.sec.gov/news/press-release/2021-42.
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[7] **https://www.law360.com/articles/1402762/top-sec-official-suggests-more-esg-enforcement-is-coming**;
https://www.law360.com/articles/1373422/sec-s-esg-unit-chief-says-existing-regs-key-to-enforcement.
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[8] **https://www.sec.gov/litigation/admin/2020/34-90031.pdf**.
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[9] *Public Input Welcomed on Climate Change Disclosures* (Mar. 15, 2021), available at **https://www.sec.gov/news/public-statement/lee-climate-change-disclosures**.
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[10] *ESG Disclosure—Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets* (Mar. 11, 2021), available at **https://www.sec.gov/news/public-statement/coates-esg-disclosure-keeping-pace-031121**.
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[11] Chair Gary Gensler, *Prepared remarks at London City Week* (June 24, 2021), available at **https://www.sec.gov/news/speech/gensler-speech-london-city-week-062321**.
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