PAUL HASTINGS

Stay Current

March 2021

Follow **@Paul_Hastings**

Immediate Steps to Consider as SEC Task Force Targets ESG Reporting

By Tara Giunta, Morgan Miller, Caroline Roberts

The Securities and Exchange Commission ("SEC") is moving quickly to respond to increasing demand from investors, consumers, and the market that it address Environmental, Social, and Governance ("ESG") disclosures and risks for entities it regulates, with particular focus on climate risk and board diversity. Since Biden was inaugurated, his Administration has taken an "all of government" approach to ESG, and most recently the SEC announced the creation of a Climate and ESG Task Force focused most immediately on identifying material gaps or misstatements in issuers' disclosures regarding climate risks. Consistent with the SEC's prior task forces, we anticipate that the Climate and ESG Task Force will be aggressive in implementing its mandate, which could result in financial and reputational adverse impact to those caught in its crosshairs.

Issuers, along with investment advisers and funds that engage in ESG strategies, should act now to evaluate their ESG risks and opportunities, ensure that current and future disclosures satisfy reporting requirements, and work to preemptively bolster any potential gaps that could attract the attention of the SEC's Climate and ESG Task Force. Recommended next steps include:

1. **Conduct Risk Assessment.** Conducting an internal ESG risk assessment is the most effective mechanism through which to establish a baseline of your company's existing ESG risks and responsive policies and procedures. The risk assessment should review how these policies and procedures have been executed in practice, allowing for rapid identification of potential gaps or areas of exposure.

2. **Review Current Disclosures**. Review existing disclosures, including formal disclosures and published statements, as well as other public representations such as your company's website. Consider whether statements made can be corroborated with supporting documentation. It will be crucial to immediately correct any inaccurate or misleading reporting.

3. **Develop Comprehensive ESG Strategy.** For issuers that have yet to develop a fulsome ESG strategy, steps must be taken quickly to develop both a playbook that defines the ESG factors that are paramount to your company and an approach for ensuring that those factors are accurately and consistently reported and disclosed. For issuers that have taken initial steps to build out an ESG strategy, this strategy should be periodically reevaluated to confirm alignment with expectations arising from increased focus on and monitoring of ESG reporting.

4. **Implement Effective Controls.** A one-time risk assessment is insufficient for guaranteeing long-term ESG compliance. Rather, your company's internal controls should encompass a framework to address ESG risks and ensure compliance with applicable policies and reporting practices. These controls should focus on the critical aspects of your ESG policy, and may include:

    a. Policies and Procedures. The foundation of all effective compliance programs is policies that articulate the company's values and commitments, including procedures laying out how the company effectuates that commitment. It is imperative that a company's ESG governance structures and compliance program include, to the extent possible, metrics against which it will assess and evaluate its ESG programs and determine its progress toward achieving its ESG goals.

    b. Monitoring and Internal Audit. Once ESG values and strategies are identified, and the company has committed to conducting business in a compliant manner, periodic audits or other reviews should be conducted to confirm that ESG commitments are being regularly met. An appropriately-scaled internal audit program should inform the company's evaluation of the effectiveness of its ESG program, flag areas for further improvement, and guide public disclosures and reporting.

    c. Due Diligence Considerations. Depending on the industry in which your company operates, it is very likely that you have existing due diligence criteria that must be met before an engagement is undertaken or relationship developed. This criteria should be dynamic, evolving to include those ESG factors that are essential to your business.

I. Increasing Focus on ESG Factors

The trend toward prioritizing ESG, including efforts to ensure that the reporting of ESG factors occurs accurately and consistently across companies to allow for the reliable comparison of companies' disclosures, is highlighted by the International Organization of Securities Commissions' (IOSCO)[1] recent finding that there is an "urgent need to improve the consistency, comparability, and reliability of sustainability reporting[.]"[2] Domestically, the current administration similarly evidenced its focus on both climate and ESG-related issues, including through President Biden's post-inauguration Executive Orders addressing climate change. The Administration's January 27, 2021 Executive Order on Tackling the Climate Crisis specifically directed that the Federal Government "drive assessment, disclosure, and mitigation of climate pollution and climate-related risks in every sector of our economy[.]"[3]

The current focus on climate risk in agencies that regulate the financial markets builds on studies released in 2020 establishing the correlation between climate risk and financial risk, and the importance of accurate and comparable reporting in evaluating these risks. Notably, the Federal Reserve System's November 2020 Financial Stability Report highlighted the economic uncertainty and financial risk created by climate change, including that imperfect information around climate-related risks results in the mispricing of assets.[4] The Report advised that climate-related financial vulnerabilities could be mitigated through "increased transparency through improved measurement and disclosure[.]" Similarly, the Group of Thirty, Co-Chaired by Janet Yellen, the current Secretary of the Treasury, tied addressing climate change to future economic viability, and called for disclosure of more useful and standardized climate-related metrics.[5]

Acknowledging that it will ultimately fall on the SEC to ensure that disclosure requirements appropriately encompass ESG concerns, in May 2020, the SEC Investor Advisory Committee approved a recommendation that the SEC update its reporting requirements for public companies to include material, decision-useful, ESG factors. Current insistence on greater ESG disclosure is unlikely to fade in the near term, and it should be expected that today's push for additional, transparent ESG disclosure will be accompanied by oversight and enforcement of existing and, potentially, newly developed, disclosure standards.

II. Recent SEC ESG Announcements and Creation of Climate and ESG Task Force

In line with continued efforts to sharpen the SEC's focus on ESG reporting in public company filings, the SEC recently issued a series of announcements regarding its focus on climate-related disclosures. On February 24, 2021, Acting SEC Chair Allison Herren Lee directed the SEC's Division of Corporation Finance to "enhance its focus on climate-related disclosure in public company filings."[6] Specifically, Corporation Finance is to consider guidance provided by the SEC in 2010 regarding climate change-related disclosures, review whether public companies addressed this guidance, assess companies' compliance with disclosure obligations under the federal securities laws, and update the 2010 guidance to account for more recent developments. The Acting Director of the Division of Corporation Finance, John Coates, similarly acknowledged that while there is "no one set of metrics that properly covers all ESG issues for all companies," the SEC should nevertheless "help lead the creation of an effective ESG disclosure system so companies can provide investors with information they need in a cost effective manner."[7] On March 3, 2021, the SEC's Division of Examinations announced that its 2021 priorities include "a greater focus on climate-related risks" for investment advisors given the increase in investor demand for ESG-conscious products, including "integrating climate and ESG considerations into the agency's broader regulatory framework."[8]

Just a day later, on March 4, 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement ("Task Force"), to be comprised of a 22-member team and led by the Acting Deputy Director of Enforcement.[9] This Task Force is to "proactively identify ESG-related misconduct," and will focus at the outset on identifying material gaps or misstatements in issuers' disclosures regarding climate risks. It will simultaneously analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies. The Task Force will utilize sophisticated data analytics to identify potential violations, and work closely with other SEC Divisions and Offices, including Corporation Finance, Investment Management, and Examinations.

Prior SEC-created task forces provide insight into the potential function of the ESG Task Force. For instance, the Enforcement Division formed a Retail Strategy Task Force in September 2017 to address the types of misconduct that most affected retail investors.[10] The Retail Strategy Task Force was active, collaborating with various law enforcement and securities regulators to investigate alleged fraud, and acted quickly where necessary, including through filing emergency actions (from 2017-2018, it issued over 20 temporary restraining orders and 30 asset freezes). Likewise, the work of the Financial Reporting and Audit (FRAud) Task Force, which was established in 2013 to identify and prosecute financial reporting violations and audit failures, led to a number of inquiries, investigations, and enforcement actions, including settlements that ran into the millions.[11] We anticipate the Climate and ESG Task Force will similarly act quickly to carry out its mandate, likely leading to tangible inquiries, investigations, and enforcement actions against companies, regulated entities, and individuals that may have engaged in ESG-related misconduct.

III. Response to ESG Announcements

While these recent announcements likely indicate that the SEC will prioritize ESG reporting and compliance, along with development of new guidance around climate and ESG-related disclosures, any material shift in ESG-related requirements remains unclear, in part due to dissent within the SEC regarding whether additional, standardized ESG reporting requirements should replace or supplement the existing principles-based disclosure framework. Notably, Commissioners Peirce and Roisman addressed the recent ESG-related announcements within the SEC and by the Acting Chair, warning against "guidance that would elicit more specific line items or otherwise convert the Commission's generally principles-based approach to a prescriptive one."[12] This response follows Commissioner Peirce's May 2020 objection to the Investor Advisory Committee's recommendation of the establishment of standardized rules regarding ESG reporting requirements as she viewed a "new SEC disclosure framework for ESG information" as "an unnecessary response when our existing securities disclosure framework is very good at handling all types of material information."[13] Commissioner Roisman similarly raised concerns around the subjective and evolving nature of ESG factors that make developing "prescriptive disclosure" difficult.[14]

Commissioners Peirce and Roisman noted that assessment of ESG disclosures already occurs, asserting that for decades Corporation Finance "has been reviewing companies' disclosures, assessing their compliance with disclosure requirements under the federal securities laws, and engaging with them on climate change and a variety of issues that fall under the ESG umbrella." While Corporation Finance is responsible for reviewing documents that companies file with the SEC, it does not appear these reviews historically were ESG-focused,[15] and thus, prioritizing review of climate-related disclosures is likely to lead to the additional identification of ESG-specific violations.

Notwithstanding certain Commissioners' hesitation around the Task Force, its creation underscores that companies should expect additional scrutiny of their ESG-related disclosures beyond prior Division of Enforcement actions. Following confirmation of the new SEC Chair, we expect further guidance on the SEC's direction in this area, including whether to expect changes to current ESG reporting requirements.

IV. Implications

For companies already reporting on their ESG commitments and programs, additional guidance and further clarity around expectations may streamline the reporting process and narrow or solidify the types of data required. Further, standardization will ideally create clarity and level the playing field so that companies' ESG practices can be more accurately compared, benefiting those companies with effective ESG policies and practices already in place.

However, for companies just beginning to address ESG requirements and reporting, additional requirements, and enhanced focus by the Task Force, brings additional costs and risks. Companies that have yet to develop ESG processes or engage in detailed ESG reporting should begin to take steps to do so.

Additionally, Task Force efforts to identify material gaps or misstatements in issuers' climate and ESG-related disclosures will result in heightened scrutiny of ESG reporting, and increased prioritization of and focus on ESG may shed public light on companies' still nascent ESG practices. The Task Force will initially focus on material gaps or misstatements in issuers' ESG disclosures based on existing rules, and companies that have failed to comply with existing guidance and disclosure obligations are at particular risk. Investment advisors with products that are specifically designed around ESG-conscious strategies are similarly subject to significant scrutiny. The SEC has historically issued comment letters regarding companies' climate-related disclosures -- and a recent GAO report concluded that "Most review staff with whom we spoke said ESG-related information generally does not rise to the level of comment unless they identify material information during background research that may be relevant to the company's operations."[16] However, given today's focus on ESG and in particular climate risk, the potential publicity and reputational damage arising from a Task Force investigation further exposes companies and their boards to potential liability. Disclosure violations arising from misreporting or misrepresenting ESG-related risks can result in scienter and non-scienter based violations of the federal securities laws, resulting in significant financial penalties, and perhaps even more costly reputational damage.

Paul Hastings is well-positioned to assist clients at every stage of the ESG-reporting process, including in conducting ESG risk assessments, developing ESG-related metrics, strategies, and programs, and engaging in decision-making around ESG disclosures. In the event of the Task Force targeting a company's disclosures or reporting, the Paul Hastings team has substantial experience in engaging with the SEC to quickly, discretely, and positively resolve inquiries.

✧ ✧ ✧

Ms. Giunta is a Vice Chair of the firm's Investigations and White Collar Practice and Mr. Miller is a partner in the firm's Washington, DC and London offices and was formerly counsel in the Division of Enforcement at the SEC in Washington. Ms. Giunta and Mr. Miller represent public companies, regulated institutions, and boards of directors in enforcement investigations and proceedings by the SEC, Department of Justice and other domestic and international regulators. They advise senior executives and boards of directors on ESG and human rights risks, as well as fraud, waste and abuse, by identifying and mitigating risks, developing and enhancing compliance programs, investigating and remediating wrongdoing and/or internal control weaknesses, and conducting transactional due diligence.

If you have any questions concerning these developing issues, please do not hesitate to contact Ms. Giunta or Mr. Miller.

Tara K. Giunta
1.202.551.1791
taragiunta@paulhastings.com

Morgan J. Miller
1.202.551.1861
morganmiller@paulhastings.com

1 IOSCO is an organization focused on securities regulation that is comprised of a membership that regulates over 90% of the world's securities markets. *See* International Organization of Securities Commissions (IOSCO), Practical Law Glossary Item 4-386-5634.

2 International Organization of Securities Commissions, *IOSCO sees an urgent need for globally consistent, comparable, and reliable sustainability disclosure standards and announces its priorities and vision for a Sustainability Standards Board under the IFRS Foundation* (Feb. 24, 2021), https://www.iosco.org/news/pdf/IOSCONEWS594.pdf.

3 Exec. Order No. 14,008, 86 FR 7619, 7622 (Jan. 27, 2021)(emphasis added).

4 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FINANCIAL STABILITY REPORT, 58-59 (November 2020).

5 GROUP OF THIRTY, MAINSTREAMING THE TRANSITION TO A NET-ZERO ECONOMY, xvi (October 2020).

6 Securities and Exchange Commission Acting Chair Allison Herren Lee, *Statement on the Review of Climate-Related Disclosure* (Feb. 24, 2021), https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure.

7 Acting Director, Division of Corporation Finance John Coates, *ESG Disclosure – Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets* (Mar. 11, 2021), https://www.sec.gov/news/public-statement/coates-esg-disclosure-keeping-pace-031121.

[8] Securities and Exchange Commission, *SEC Division of Examinations Announces 2021 Examination Priorities: Enhanced Focus on Climate-Related Risks* (Mar. 3, 2021), https://www.sec.gov/news/press-release/2021-39.

[9] Securities and Exchange Commission, *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues* (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42.

[10] Chairman Jay Clayton, *Remarks on the Establishment of the Task Force on Market Integrity and Consumer Fraud* (July 11, 2018), https://www.sec.gov/news/speech/task-force-market-integrity-and-consumer-fraud.

[11] U.S. Securities and Exchange Commission, *Spotlight on Financial Reporting and Audit (FRAud) Group* (Feb. 11, 2019), https://www.sec.gov/spotlight/financial-reporting-and-audit-task-force.shtml.

[12] Commissioner Hester Peirce and Commissioner Elad Roisman, *Enhancing Focus on the SEC's Enhanced Climate Change Efforts* (Mar. 4, 2021), https://www.sec.gov/news/public-statement/roisman-peirce-sec-focus-climate-change.

[13] Commissioner Hester Peirce, *Remarks at Meeting of the SEC Investor Advisory Committee* (May 21, 2020), https://www.sec.gov/news/public-statement/peirce-statement-investor-advisory-committee-meeting-052120#_ftnref1.

[14] Commissioner Elad Roisman, *Keynote Speech at the Society for Corporate Governance National Conference* (July 7, 2020), https://www.sec.gov/news/speech/roisman-keynote-society-corporate-governance-national-conference-2020.

[15] United States Government Accountability Office, Public Companies: Disclosure of Environmental, Social, and Governance Factors and Options to Enhance Them, Report to the Honorable Mark Warner U.S. Senate 35 (2020).

[16] *Id*. at 36.