

Technical Line

Revisiting the SEC's guidance on climate change disclosures in today's environment

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Now more than ever, investors are considering climate-related issues when making their investment decisions.

— SEC Acting Chair
Allison Herren Lee

What you need to know

- ▶ Companies should reevaluate their disclosures related to climate change and other environmental, social and governance (ESG) matters in light of the increase in focus on these matters at the SEC.
- ▶ If companies add or modify climate change or ESG disclosures in their SEC filings, they should have sufficient disclosure controls and procedures (DCPs) over the new information.
- ▶ The SEC staff in the Division of Corporation Finance has been directed to assess compliance with the Commission's 2010 guidance on climate-related disclosures and to consider updating that guidance, and a task force has been created in the Enforcement Division to pursue potentially misleading ESG disclosures or omissions of material information related to these matters.
- ▶ Companies should consider responding to the SEC's request for comment on how to best regulate these disclosures and monitor developments for potential rulemaking on these topics.

Overview

With new leaders serving in acting roles, the Securities and Exchange Commission (SEC or Commission) has increased its focus on disclosures related to climate change and other ESG matters.

Since her appointment in January, Acting Chair Allison Herren Lee has **directed** the Division of Corporation Finance (DCF) to enhance its focus on climate-related disclosure in public company filings by reviewing the extent to which public companies are addressing the topics identified in the Commission's **2010 climate change guidance** and considering updating that guidance to take into account developments over the last decade. Ms. Lee also requested **public comment** on how the SEC can best regulate climate change disclosures and created a **Climate and ESG Task Force** in the Division of Enforcement that will focus on possible misconduct related to ESG disclosures.

The emphasis on climate and other ESG disclosures is expected to continue under Gary Gensler, President Joseph Biden's nominee to chair the SEC, whose appointment is subject to Senate confirmation.

Our publication revisits the SEC's 2010 guidance, which addressed how the existing SEC disclosure rules applied to climate change matters and the types of disclosures that might be required, in light of today's environment. It is aimed at helping registrants apply the guidance today and respond to any inquiries from the SEC staff about their disclosures.

Climate change considerations

The 2010 guidance says companies may need to make climate change disclosures under Regulation S-K in the description of the business (Item 101), discussion of legal proceedings (Item 103), risk factor disclosures (Item 105) and/or management's discussion and analysis (MD&A) (Item 303).¹ Securities Act Rule 408 and Exchange Act Rule 12b-20 also require a company to disclose any other material information necessary to make the required disclosures not misleading.

The 2010 guidance identifies several considerations for companies that are evaluating whether disclosure regarding climate change is appropriate.

Legislation and regulation

The 2010 guidance indicates that a company should consider specific risks it faces as a result of climate change legislation or regulation and avoid generic or boilerplate risk factor disclosure. For example, power companies and car makers may consider disclosures related to President Biden's plan to use the government's buying power to make the nation's electricity sector carbon pollution-free by 2035 and achieve net zero emissions throughout the economy by 2050, but they would need to tailor any disclosures to the specific risks they face.²

Companies are also required to assess whether any enacted climate change legislation or regulation is reasonably likely to have a material effect on their financial condition or results of operations. In the case of a known uncertainty, such as whether proposed legislation or regulation will be enacted, the 2010 guidance indicates that management must consider disclosures, unless it determines that the proposal is not reasonably likely to be enacted. Management must then determine whether the legislation or regulation, if enacted, is reasonably likely to have a material effect on the company's business. Disclosure is required, unless management determines that a material effect is not reasonably likely. The company also would have to consider disclosure, if material, of the difficulties involved in assessing the timing and effect of the proposed legislation or regulation.

The 2010 guidance states that a company should not limit its disclosure of the reasonably likely effects of a proposed law to potential negative consequences. The 2010 guidance notes that changes in laws or in business practices in response to those changes may provide new opportunities. For example, under a "cap and trade" system, some companies may profit from the sale of allowances if their emissions levels are below their emissions allotment. Likewise, companies that are not covered by statutory emissions caps may be able to profit by selling offset credits.

Companies need to consider reputational risk as a potential indirect risk of climate change.

International accords

The 2010 guidance indicates that companies should disclose material effects on their business of treaties or international accords relating to climate change. Companies operating in countries that signed the Paris Agreement,³ which set a long-term temperature goal, may consider disclosing the effects of any national policies, laws or regulations aimed at reducing emissions to meet that commitment.

Indirect consequences

Legal, technological, political and scientific developments relating to climate change may create new opportunities or risks for companies, such as increases in both demand for goods with low emissions and competition to develop them. These trends may require disclosure as risk factors or in MD&A. They could also have such a material effect on a company's business (e.g., for a maker of electric vehicles or solar panels) to require disclosure in its business description.

The 2010 guidance also states that a company must consider reputational risk as a potential indirect risk of climate change. For example, more businesses globally have taken initiatives to reduce their emissions in line with the Paris Agreement. If the momentum of similar voluntary activities grows, companies that have not followed suit should consider the possibility of reputational damage they might suffer if they are out of step with their peers.

Physical effects

The 2010 guidance indicates that significant physical effects of climate change, such as weather events (e.g., floods, hurricanes), rising sea levels, a decrease in arable farmland, and water availability and quality, have the potential to affect a company's operations and results.

Companies whose businesses may be vulnerable to severe weather or other climate-related events, directly or indirectly, should consider disclosing material risks of, or consequences from, such events in their SEC filings. We note that some registrants in California are now making disclosures about their vulnerability to future droughts and wildfires that would affect both the health and safety of employees. Also, companies with material operations near a coast may need to disclose actual or reasonably likely material increases in their insurance premiums due to the rising sea levels and expanded flood zones as a result of global warming.

Environmental goals and commitments

Many companies disclose their environmental goals and commitments (e.g., achieving carbon neutrality or decreasing greenhouse gas emission within a certain time period) outside of their SEC filings. They need to consider whether they have reporting obligations under the SEC's existing disclosure requirements, as discussed above. For example, if achieving their goals or fulfilling their commitments will require significant capital expenditures, companies should make that clear in MD&A.

When making such disclosure in SEC filings, companies should make sure they have sufficient controls and procedures for setting climate-related goals and periodically assessing the potential impact. Likewise, companies that also report their progress toward their goals should have adequate controls and procedures for determining that progress. In addition, companies should consider whether any known uncertainties exist with respect to achieving the goals that require disclosure.

We have observed an increase in disclosures related to companies' targets for ESG metrics and performance against those targets, as well as an increase in risk factor disclosures related to the adverse effects, including potential reputational damage, of failing to achieve adequate progress toward meeting the targets on a timely basis.

Governance

Registrants are required to establish and maintain appropriate and effective DCPs to make sure that relevant information about climate and other ESG risks and effects is processed and reported to the appropriate personnel, including senior management responsible for making disclosure decisions and certifying the information contained in SEC filings.

Under SEC rules, a registrant must disclose whether its DCPs are effective each quarter and that the chief executive and chief financial officer each take responsibility for the design and evaluation of the DCPs, as required by the Sarbanes-Oxley Act.

The following questions may be helpful for companies considering adding new ESG disclosure to their SEC filings in response to the renewed focus:

- ▶ Where does the information (e.g., data) supporting the disclosure reside?
- ▶ Is such information prepared internally or externally? If it is prepared internally, is it centrally located or does it need to be compiled from various locations manually?
- ▶ What DCPs, if any, currently exist for the information?
- ▶ What additional DCPs would be needed to meet the SEC requirements?
- ▶ What controls are necessary to make sure that any metrics are calculated consistently or that any changes to the methodology are disclosed?
- ▶ What processes need to be put in place to make sure that the new information can be added to a filing without compromising timeliness?
- ▶ Who should participate in a cross-functional team (e.g., external reporting, legal, investor relations) to review the disclosures and close any gaps?

What's next

We expect the SEC staff to look more closely at registrants' disclosures on climate and ESG issues that are presented inside and outside of periodic reports filed with the Commission. Companies should be ready to respond to inquiries from the SEC staff about whether their disclosures comply with the 2010 guidance. In addition, companies should consider responding to the SEC's request for comment on how to best regulate climate change disclosures and providing input before the SEC starts the rulemaking process on ESG matters.

Endnotes:

- ¹ The SEC adopted amendments to Regulation S-K that amended Items 101, 103, 105 and 303. See Releases No. [33-10825](#) and No. [33-10890](#). We do not believe the amendments have changed or will change related to how registrants should evaluate their disclosures related to climate change and other ESG matters.
- ² [Executive Order on Tackling the Climate Crisis at Home and Abroad, 27 January 2021](#).
- ³ The Paris Agreement, United Nations Climate Change: <https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement>.

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