

Governance and Disclosure Considerations from the SEC's Climate Change Comment Letters

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by Cam C. Hoang

The SEC's Division of Corporation Finance has issued [a sample comment letter](#), and sent actual comment letters to a series of public companies, asking for additional Form 10-K disclosure on topics addressed in the SEC's [2010 Guidance Regarding Disclosure Related to Climate Change](#), Release No. 33-9106 (Feb. 2, 2010), or an explanation for why the comments do not apply. The comment letters are a preamble to the SEC's rulemaking, which is now expected early in 2022.

In his recent remarks on mandatory climate change disclosure,¹ SEC Chairman Gary Gensler noted that investor demand is driving SEC rulemaking: "Investors today are asking for that ability to compare companies with each other. Generally, I believe it's with mandatory disclosures that investors can benefit from that consistency and comparability. When disclosures remain voluntary, it can lead to a wide range of inconsistent disclosures."

SEC Comment Letters

In its comment letters, the SEC has suggested that it will continue to monitor climate change disclosure beyond SEC filings. Companies are asked to explain what consideration was given to providing the same type of climate-related disclosure in SEC filings as was provided in more expansive disclosure in corporate social responsibility (CSR) reports. This comment prompts companies to evaluate the consistency of their disclosure across multiple platforms. Specifically, companies may re-consider whether and when to use the term "material," and what it means in an SEC filing versus a CSR report or a website. When used to qualify a requirement for the furnishing of information in a registered securities offering, the SEC definition of "materiality" limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered.²

Furthermore, the comments request Management's Discussion & Analysis disclosure, to

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- Cam C. Hoang

Related Capabilities

- Corporate Governance & Compliance
- Securities & Financial Services Litigation & Enforcement
- Environmental, Social, Governance (ESG)

the extent material, of:

- the effect of pending or existing climate-change legislation and international accords on the business, financial condition and results of operations,
- capital expenditures for climate-related projects,
- indirect consequences of regulations or business trends, such as changes in demand for goods or services based on carbon emissions,
- weather-related and other physical effects of climate change on operations and results, and
- quantification of increased compliance costs related to climate change.

Companies have also been asked to add or update material risk factors related to climate change, including potentially:

- transition risks related to climate change that may affect the 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, and
- litigation risks related to climate change and the potential impact on the company.

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A transition from principles-based disclosure to more prescriptive disclosure.

Disclosure rulemaking under the previous administration was predominantly principles-based, with broadly defined topics and significant discretion given to companies to include disclosure only if it was material. The SEC's climate change rulemaking will be more prescriptive, potentially adopting a "comply or explain" approach or a mix of mandatory and voluntary disclosure on topics such as climate change risk factors; how climate change is impacting governance, strategy and risk management; and quantitative disclosures on carbon emissions. Chairman Gensler has asked the SEC staff to consider quantitative disclosures such as the financial impacts of climate change, progress towards goals such as net-zero carbon emissions and metrics related to greenhouse gas (GHG) emissions-specifically, how companies should disclose their Scope 1 and Scope 2 GHG emissions. Scope 1 direct GHG emissions occur from sources that are controlled or owned by an organization and Scope 2 indirect GHG emissions are associated with the organization's purchase of electricity, steam, heat or cooling in its operations.³ Chairman Gensler also asked the SEC staff to consider whether and under what circumstances companies should be required to disclose their Scope 3 GHG emissions. Scope 3 GHG emissions are the result of activities from assets not owned or controlled by the reporting organization, but that the organization indirectly impacts in its value chain, whether upstream from its operations (e.g., emissions from supplier distribution and transportation) or downstream from its operations (e.g., emissions from consumer use of sold products).⁴

Governance review of policies, goals and disclosure. Senior management and boards should be prepared to oversee climate change policies, goals and disclosure. Committee charters should be reviewed and updated as necessary to reflect mandates

for climate change oversight and disclosure. Similarly, disclosure controls and procedures should be reviewed, with attention given to ensuring consistency of climate change disclosure and establishing a framework for evaluating the materiality of disclosure. Management and the board should have access to the right expertise, whether in-house, on the board and/or through external advisors.

More robust stakeholder engagement on climate change and other ESG issues.

Senior management and boards should lay the foundation for disclosure with in-depth discussions on their companies' ESG priorities, and how these priorities are aligned with their business strategies. Companies should become familiar with their stakeholders' expectations through regular engagement that includes not only investors, but employees, local communities and other stakeholders. Activist investor Engine No. 1's successful proxy campaign to replace three of ExxonMobil's directors in the last proxy season shows that activists with a relatively small ownership stake can gain the support of larger investors who are dissatisfied with a company's performance and its strategy for adapting the business to climate change trends.

Multiple frameworks for disclosure. Companies should be evaluating multiple frameworks for disclosure and performing a "gap analysis" to compare a given framework's prescriptions against their actual practices. However, companies do not necessarily need to choose one framework, and should treat this as an evolving analysis. The SEC rulemaking may signal preferences for certain frameworks.

Chairman Gensler has asked the SEC staff to "learn from and be inspired by"⁵ the Task Force on Climate-related Financial Disclosures (TCFD) framework, which is based on four key principles of financial disclosure:

- Governance – Disclose the organization's governance around climate-related risks and opportunities.
- Strategy – Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.
- Risk Management – Disclose how the organization identifies, assesses, and manages climate-related risks.
- Metrics and Targets – Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

Addressing financial impact of climate change and other ESG issues. Public companies, especially among the S&P 500, are increasingly discussing their approach to climate-related governance and risk management and in some cases outlining carbon emissions goals and progress against those goals. However, most companies are still grappling with how to describe and quantify any financial impact of climate change and their response to climate change. The Financial Accounting Standards Board (FASB) staff developed an [educational paper](#) to provide investors and other interested parties with an overview of the intersection of ESG matters with financial accounting standards. The paper also provides examples of how a company may consider the effects of material ESG matters when applying current accounting standards. As described in the paper, some ESG matters may directly affect amounts reported and disclosed in the

financial statements, for example, through the recognition and measurement of compensation expense. Other ESG matters may indirectly affect the financial statements; for example, an entity may suffer reputational damage from an environmental contamination that reduces sales. Other ESG matters may not have any material effect on the financial statements. Accounting standards topics addressed include going concern; risks and uncertainties; inventory; intangibles; property, plant and equipment; asset retirement and environmental obligations; contingencies; income taxes and fair value measurement. FASB notes that industry-specific accounting guidance should also be consulted.

¹ Principles for Responsible Investment “Climate and Global Financial Markets” Webinar on July 28, 2021.

² Rule 405 of the Securities Act of 1933, as it was revised in 1982 in keeping with the Supreme Court decisions in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), as reaffirmed in *Basic Inc. v. Levinson*, 485 U.S. 224, 234 (1988).

³ See the EPA Center for Corporate Climate Leadership’s “Scope 1 and Scope 2 Inventory Guidance.”

⁴ See the EPA Center for Corporate Climate Leadership’s “Scope 3 Inventory Guidance.”

⁵ Principles for Responsible Investment “Climate and Global Financial Markets” Webinar on July 28, 2021.