

INSIGHTS

Aligning ESG and 10-K Disclosures: A Perspective from a Chief Legal Officer

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To say the SEC has signaled increased attention to ESG matters would be an understatement. Between February 24th and April 12th of this year, the SEC has posted on its website five public statements and two press releases that have a primary focus around ESG disclosures. The SEC also announced the creation of a Climate and ESG Task Force in the Division of Enforcement. The task force will include 22 members from the SEC's headquarters, regional offices, and enforcement specialized units. Initially the task force will focus on material gaps or misstatements in issuers' disclosure of climate risks under existing rules and will analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies. Acting Deputy Director of Enforcement Kelly L. Gibson, who will lead the task force, pointed out that "Proactively addressing emerging disclosure gaps that threaten investors and the market has always been core to the SEC's mission."¹

This may be a reaction to the greatly increased disclosures that issuers are starting to provide around ESG. Increased ESG reporting may be due to pressure from investors and other stakeholders in many cases and as a result of good corporate governance processes in other cases, or a combination of both. But what exactly will be the focus of SEC reviews, enforcement and guidelines and what risks are there to issuers in providing meaningful ESG reports outside their traditional 34 Act filings? My perspective on that answer is shaped by my years as Chief Legal Officer for a major publicly traded corporation.

SEC Focus on ESG Disclosures

The SEC will likely begin by focusing on the 2010 interpretive release that provided guidance to issuers as to how existing disclosure requirements apply to climate change matters. At this point, that release provides the most substantial formal guidance that has been issued directly related to ESG. Acting Chair Allison Herren Lee noted in a March 15, 2021 Public Statement that under the 2010 Climate Change Guidance, "depending on the circumstances, information about climate change-related risks and opportunities might be required in a registrant's disclosures related to its description of business, legal proceedings, risk factors, and management's discussion and analysis of financial condition and results of operations. The release outlined certain ways in which climate change may trigger disclosure obligations under the SEC's rules. It noted legislation and regulations governing climate change, international accords, changes in market demand for goods or services, and physical risks associated with climate change."² In other words, the disclosure contemplated by the 2010 Climate Change Guidance would be in existing Form 10-K disclosures. However, there is no question the current market expectation of ESG reporting goes well beyond the 2010 Climate Change Guidance and current Form 10-K disclosures.

In that same March 15, 2021 Public Statement, Acting Chair Lee issued a public statement welcoming public input on climate change disclosures.³ Of the 15 topics presented in that public statement for feedback, 14 center around climate change-related disclosures. The 15th topic presents a potential umbrella for comments around ESG disclosure and considers making climate related requirements a component of a broader ESG framework. In speaking to the Tulane Corporate Law Institute in March of this year, John Coates, Acting Director of the SEC's Division of Corporation Finance, touched on the complexities around potential ESG disclosure requirements, indicating that substantial debate remains "over the precise contents and details of what ESG disclosures might or should encompass." Acting Director Coates went on to note as follows:

"Part of the difficulty is in the fact that ESG is at the same time very broad, touching every company in some manner, but also quite specific in that the ESG issues companies face can vary significantly based on their industry, geographic location and other factors. As such, there is no one set of metrics that properly covers all ESG issues for all companies. Moreover, the landscape is changing rapidly so issues that yesterday were only peripheral today are taking on greater importance. It is against this backdrop that I think about the regulation of ESG disclosures."⁴

Based on these public statements, it is clear the SEC wants to, and most likely will, issue more formal guidelines for ESG disclosures. It is not clear what form those guidelines will take. As a former Chief Legal Officer, I believe it is critical that the SEC issue better defined guidelines for ESG reporting overall. The lack of formal guidelines or a common standard for reporting requires in-house lawyers to perform additional due diligence around any disclosures made in ESG reporting. Acting Director Coates in his address to the Tulane Corporate Law Institute pointed out that "companies generally are mandated to make disclosures as needed to prevent other disclosures from being materially misleading. As companies continue to disclose more in sustainability reports, they should already be evaluating those disclosures in light of existing anti-fraud obligations."⁵

Alignment with other SEC Reports

My experience as CLO taught me to focus closely on publications the company makes to investors or internal risk assessment that the company may perform and how those disclosures and assessments align with SEC reporting. With respect to ESG reporting, various groups in the company, usually focused around Investor Relations and Health Safety and Environmental, will coordinate an ESG report that is posted on the website and distributed to key stakeholders. The ESG reporting will generally have a marketing orientation. While the legal department should and generally does have a seat at the table, the lack of formal SEC guidelines may create an illusion that the legal department should have less input on the report—and that ESG statements are somehow insulated from the standards applied to more formal shareholder communications. Real danger exists in the misalignment of ESG-related statements and other SEC disclosures the company has made.

As your company begins to prepare and distribute ESG disclosures, whether that be as part of its formal SEC reporting or in supplementary disclosures on its websites or distributed to investors, here are three practices I would suggest:

1. **Review the disclosures from a Rule 10b-5 perspective.** Is there any additional disclosure that is needed to prevent any of the statements in the disclosure from being misleading? Be

careful not to rely on materiality as a justification. As new ESG requirements emerge, we will likely see new materiality standards applied.

2. **Consider the precedents being set by the disclosure.** As initial disclosures are being made or existing disclosures are being expanded, there may be a tendency to report all positive trends regardless of materiality. However if there are subsequent negative trends in those less material areas, there may be pressure to omit those metrics from subsequent reports. Consider the Rule 10b-5 implications of those trends being omitted in a negative year.

3. **Be sure that disclosure aligns with your Form 10-K or other SEC reporting.** For example, do risk assessments that are done as part of an Enterprise Risk Management process (even if only distributed internally) or ESG disclosures that discuss risks, materiality or priorities align with the risk factors that are presented and discussed in your Form 10-K? And do not confine your assessment to the most recent Form 10-K and ESG report—both shareholders and the SEC will be looking at several years' worth of annual reports and ESG statements as they look for specific incongruities as well as the broader narratives.

One last point. A glance at peer disclosure can be illuminating—but not necessarily comforting. I once did a review of the Form 10-K's for several large companies in the same sector. In the review I produced a chart that listed each risk described in the Form 10-K's and then checked each company that listed that risk. I expected to find that these companies disclosed many of the same risks, and they did. What surprised me was the number of times one company reported a risk or risks that none of the others did. This was a valuable exercise for me in evaluating how well risk factors in a Form 10-K aligned with internal risk assessments and other disclosures.

1. SEC Announces Enforcement Task Force Focused on Climate and ESG Issues, **RELEASE 2021-42** (March 4, 2021)

2. <https://www.sec.gov/news/public-statement/lee-climate-change-disclosures>, citing the **Commission Guidance Regarding Disclosure Related to Climate Change**, Release No. 33-9106 (Feb. 2, 2010) [75 FR 6290 (Feb 8, 2010)] (2010 Climate Change Guidance).

3. <https://www.sec.gov/news/public-statement/lee-climate-change-disclosures>

4. ESG Disclosure – Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets; <https://www.sec.gov/news/public-statement/coates-esg-disclosure-keeping-pace-031121>

5. *ibid*