# Climate Change Risk and Disclosure: A New Focus for SEC Enforcement

*Given the massive amount of dollars being poured into ESG funds and the SEC's renewed focus on both the funds and the companies in the funds, there is no time like the present for companies to engage in an assessment of their climate risks and how these risks and the status of the companies' ESG goals are being relayed to investors.*

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At a time when climate change has been referred to by the President of the United States as our "existential crisis," and investors are pouring trillions of dollars into green, sustainable funds, more and more companies and investment funds are touting their climate and environmental bona fides. In April of this year, Mastercard announced that it was going to link all employee bonuses to meeting ESG (environmental, social and governance) goals. See, "Mastercard (MA) to Tie All Employee Bonuses to Meeting ESG Goals," Bloomberg (April 19, 2022). Similarly, in March of this year, Goldman Sachs announced that directors at companies in which Goldman invests who fail to provide sufficient climate risk disclosure are at risk of being voted out by Goldman.

These are important and laudable steps. But as evidenced by the SEC's recent activities and announcements, doing well while doing good carries with it some risks.

Issuers and other registrants with the SEC are required, in their SEC filings, including their annual reports, to disclose material information; that is, information that a reasonable investor would consider important in deciding how to vote or make an investment decision, or would have altered the total mix of available information. See, e.g., Basic v. Levinson, 485 U.S. 224, 231 (1988). Failure to do so can result in SEC action and in the most egregious cases a referral to the DOJ who may decide to prosecute. Similarly, false statements or a material omission in a company's marketing materials, analyst calls or other interactions with shareholders or potential investors can result in similar enforcement actions, not to mention shareholder suits. All one has to look to is the recent prosecution of Theranos founder Elizabeth Holmes.

Therefore, the SEC's and DOJ's monitoring the truthfulness and fulsomeness of companies' statements and disclosures to their shareholders and potential shareholders is not new; even monitoring statements that relate to climate risk have been on the SEC's radar. For example, in 2010, the SEC released "Commission Guidance Regarding Disclosure Related to Climate Change," Feb. 2, 2010 (2010 Guidance). The SEC noted certain areas on which it suggested registrants' focus: climate change's risk to the business itself, including from floods, wildfires and other natural disasters; the cost of compliance — that is the material impact compliance has on earnings and capital expenditures, particularly in the oil and gas industry, and the cost of failure to comply with international climate risk mitigation regimes for multinationals subject to those regimes (e.g., the Kyoto Protocols or today, the Paris Accords). See also, 17 CFR 229.101(e)(2)(i).

The SEC even suggested an issuer disclose a decrease in demand for its goods as a result of not being competitive in terms of climate change compliance metrics. 2010 Guidance at 25. This was an early recognition the climate change was more than a cost of doing business — it could have a profound impact on the lifeblood of the business itself.

That said, the 2010 Guidance relied on then current regulations and case law intended to cover disclosures generally; there was nothing the Guidance could point to in terms of a directive addressing the specifics of climate change risk.

And there was no mention at that time about companies proactively touting their sustainability creds in their SEC filings, investor communications, analyst calls or press releases and whether that “disclosure” was accurate. Nor was there clarity as to which industries, other than oil and gas, could be materially impacted by climate change.

In other words, disclosing climate change’s risk to a company’s business or the value of a fund was essentially voluntary using the general metrics for disclosure.

By 2020, 10 years after the SEC’s 2010 guidance, confusion continued to reign in what needed to be disclosed and what didn’t. See, U.S. Gov’t Accountability Office, GAO-20-530, Public Companies: Disclosure Of Environmental, Social, And Governance Factors And Options To Enhance Them (July 2020) (concluding that companies ESG disclosures are inconsistent).

Last year brought us the perfect storm: money held in sustainable mutual funds and ESG-focused exchange-traded funds rose globally by 53% to $2.7 trillion, with a net $596 billion flowing into the strategy, according to Morningstar Inc. Bloomberg estimated that all ESG invested assets were poised to reach $41 trillion in 2022. Id. This, coupled with the increase in companies and funds claiming they were green and ESG focused caught the government’s eye.

On May 20, 2021, President Biden announced in his “Executive Order on Climate-Related Financial Risk”:

> The intensifying impacts of climate change present physical risk to assets, publicly traded securities, private investments, and companies …. It is therefore the policy of my Administration to advance consistent, clear, intelligible, comparable, and accurate disclosure of climate-related financial risk ….

It was not just the United States focusing on financial disclosure of climate risk. In 2015, the Financial Stability Board, which brings together senior policy members from the G20 countries, along with Michael Bloomberg, created the Task Force on Climate-Related Disclosure (TFCRD). Since then, the TFCRD, has published metrics for financial disclosure of climate risk; metrics that are used by corporations worldwide. In its 2021 report, the TCFD noted the importance of these metrics, “In a rapidly evolving climate risk landscape, transparency on climate-related issues is increasingly critical for investors, lenders, and insurance underwriters to make informed economic decisions.”

Two months after the White House’s Executive Order, SEC Commissioner Gary Gensler responded to the White House’s call for action. In a YouTube video, he discussed both climate change risks to companies in terms of their earnings, costs and very being, as well as the truthfulness of companies’ disclosures and communications to shareholders and potential investors about what they are doing in terms of redressing climate change; that is, were they exaggerating their commitment to or achievement of climate related goals? In other words, were they “greenwashing?” See, “The SEC & Climate Risk Disclosure | Office Hours with Gary Gensler,” YouTube (July 28, 2021).

Less than a year later, on March 21, 2022, the SEC announced proposed rule changes that would require issuers and other registered companies to make more extensive climate-related disclosures in their annual reports and other SEC filings than those currently suggested. More specifically, the proposed rule changes would require a registrant to disclose its policies and procedures that are intended to manage climate risk; whether and how any such identified risks have had, or are likely to have, a material impact on its business, operations or financials; how such risks have or could impact on the issuer’s strategy or business model, and the impact of climate-related events on the financials, including on the assumptions used in the financials. The proposed rule also imposes obligations to make certain more specific disclosures relating to greenhouse gas emissions.

And as to those issuers who have “publicly set climate-related targets or goals, the proposed amendments would require certain disclosures to enable investors to understand those aspects of the registrants’ climate risk management.” Id.

All of these changes are geared to the “investors representing literally tens of trillions of dollars [who] need reliable information about climate risks to make informed investment decisions.” Id.

Although the proposed rules are still in the comment stage, the SEC is already beginning to act.

On April 28, 2022, the SEC sued Vale SA, one of the largest iron ore miners in the world, for making false ESG claims in its filings in connection with its Brumadinho dam that collapsed in 2019, resulting in the death of 270 people. See, “SEC Charges Brazilian Mining Company with Misleading Investors about Safety Prior to Deadly Dam Collapse.” In the press release, Gurbir S. Grewal, Director of the SEC’s Division of Enforcement said:

> “Many investors rely on ESG disclosures like those contained in Vale’s annual Sustainability Reports and other public filings to make informed investment decisions …. By allegedly manipulating those disclosures, Vale compounded the social and environmental harm caused by the Brumadinho dam’s tragic collapse and undermined investors’ ability to evaluate the risks posed by Vale’s securities.”

On March 3, 2022, Commissioner Gensler released another YouTube video dealing with climate risk — this time, his target was “sustainable” and “green” funds. Note that he used air parenthesis when discussing these funds. The Commissioner set his sights on any fund that represents itself as investing in green and sustainable companies but which, in fact, is not doing so. He stressed that investors need to know the criteria the fund is using to determine that its investment is green and be able to see the data that supports the determination. See, “ESG Investing | Office Hours with Gary Gensler,” YouTube (March 3, 2022).

On March 30, 2022, the SEC’s Division of Examination — the Division that conducts audits — announced its 2022 examination priorities. See, “2022 Examination Priorities Report.” One of those priorities is whether registered investment advisers and registered funds are accurately disclosing their ESG investment strategy and whether they have adopted policies and procedures designed to prevent violations of the securities laws in connection with their ESG disclosures. Much of the focus will be on whether in its advertising or marketing materials, the fund or financial advisor overstates or misrepresents the ESG factors considered in the fund’s portfolio selection..What is important to keep in mind is that the Division of Examination does not merely conduct audits. It serves as a referral source to the SEC’s Division of Enforcement, including the Division’s Climate and ESG Task Force, now just a year old, and tasked with investigating material gaps and misstatements in issuers’ climate risk disclosures as well as investment advisor and ESG fund strategies.

And the Task Force does not need to wait to see if the proposed rule changes are promulgated. Section 35(d) of The Investment Company Act of 1940 and the rules promulgated thereunder — also known as the “naming convention” rule — require funds using names that indicate that they invest in certain types of companies or industries to have 80% of their assets invested in such companies or industries; failure to do so could render the name misleading. Any fund touting itself as investing in green or sustainable industries could find itself deemed to be running afoul of the naming convention rule, if it does not have the data supporting the “greenness” of its portfolio.

Any company, investment advisor or fund communicating with investors about its ESG or climate risk bona fides should allocate sufficient resources to familiarize itself with the new rules and proposed rules.

Although there is an argument to be made that until the proposed rules are actually implemented, a company does not need to consider whether the new rules will have a material impact on its business and, hence, worry about the disclosure issues, that would probably not be the most prudent path. See e.g., “Interpretation: Commission Guidance Regarding Disclosure Related to Climate Change,” at 22-23 (Feb. 8, 2010). (First, management must evaluate whether the pending legislation or regulation is reasonably likely to be enacted. Unless management determines that it is not reasonably likely to be enacted, it must proceed on the assumption that the legislation or regulation will be enacted.)

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