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Climate Change Risk Disclosures and the Securities and Exchange Commission

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SUMMARY

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Rena S. Miller
Specialist in Financial Economics

Gary Shorter
Specialist in Financial Economics

Nicole Vanatko
Legislative Attorney

Climate Change Risk Disclosures and the Securities and Exchange Commission

Potential risks to the U.S. financial system from climate change have attracted growing attention in government, academia, and media, raising questions about the roles of financial regulators in addressing such risks. Scientific assessments have concluded that human activities—and particularly carbon dioxide and methane emitted by fossil fuels, agriculture, and land use change—are extremely [>95% likelihood] likely the primary driver of the rise of global average temperature since 1950. Climate change—defined by the Federal Reserve as "the trend toward higher average global temperatures and accompanying environmental shifts such as rising sea levels and more severe weather events"—may impact multiple financial regulators' responsibilities, including those of ensuring financial stability. Risks from climate change may belong to the category of *physical risks*, such as heavier and more frequent storms or wildfires that impose direct losses. Or they may consist of *transition risk*, meaning the risk that changing government policies or market perceptions might lead to sudden asset price drops, such as for carbon-emitting industries. A 2020 report by the Commodity Futures Trading Commission (CFTC) found that climate change could pose systemic risks to the U.S. financial system.

The Securities and Exchange Commission's (SEC's) mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. As part of this mission, the SEC issued "Guidance Regarding Disclosure Related to Climate Change" in 2010 to assist publicly listed companies in evaluating when climate change risks require disclosure. However, the 2020 CFTC report concluded that the 2010 SEC guidance has not resulted in high-quality disclosure of climate change risks across U.S. publicly listed firms, and that it should be updated in light of global advancements over the preceding 10 years. In July 2021, SEC Chair Gary Gensler announced that he had instructed SEC staff to develop a mandatory climate risk disclosure rule proposal for the commission's consideration, citing a high level of investor demand. The amount of money involved in adequate disclosure of risks from climate change for equity investors is potentially large. The total market capitalization of the U.S. stock market at the end of 2020 was about $50.8 trillion. Some studies have estimated the dollar risks from undisclosed climate-related risks to also be large. Two central questions are whether, and to what degree, emergent climate change risks are of material importance to investors, and to what degree current disclosures of climate change risks have been useful to investors. A 2018 GAO report examined the steps taken by the SEC to aid companies' understanding of the disclosure regime for climate-related risks. GAO observed that some filings had climate-related disclosures that used boilerplate language that was not company-specific and thus lacked quantification.

The SEC also appears to be reexamining disclosures by "Environmental, Social and Governance" (ESG) funds. Though there is no legally binding definition of what constitutes an ESG fund, the term refers to portfolios of equities and/or bonds—typically mutual funds—for which environmental, social, and governance factors are integrated into the investment process. The SEC's Division of Investment Management has primary responsibility for administering the Investment Company Act of 1940 (15 U.S.C. §§ 80-1 et seq.) and the Investment Advisers Act of 1940 (15 U.S.C. §§ 80b-1 et seq.) which includes developing regulatory policy for investment companies (such as mutual funds) and for investment advisers. The SEC does not have rules that specifically govern the use of ESG principles or their disclosures relevant to climate change. In recent years, funds marketed to investors as "ESG" have grown markedly in terms of assets under management. More recently, the SEC announced creation of an ESG Task Force to analyze disclosure and compliance issues relating to ESG strategies. In April 2020, the SEC's Division of Examinations warned that its review of ESG funds had found a number of misleading statements regarding ESG investing processes and adherence to global ESG frameworks, among other issues. In July 2021, SEC Chair Gensler noted the absence of a "standardized meaning" of such so-called ESG, green, or sustainable funds. He then indicated that he had requested that the SEC staff consider recommendations on whether managers of such sustainable funds need to disclose the criteria and underlying data they employ. On September 22, 2021, the SEC's Division of Corporate Finance, referencing the 2010 climate change guidance, issued sample letters for public companies to guide them in their climate-related corporate disclosures. The sample letter directed companies to consider in their disclosures the impact of pending or existing climate-change-related legislation, regulations, and international accords; the indirect consequences of regulation or business trends; and the physical impacts of climate change on their businesses.

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Climate Change and the Financial Sector

Potential risks to the U.S. financial system from climate change have attracted growing attention in government, academia, and media, raising questions about the roles of financial regulators in addressing such risks. Scientific assessments have concluded that human activities—and particularly carbon dioxide and methane emitted by fossil fuels, agriculture, and land use change—are extremely [>95% likelihood] likely the primary driver of the rise of global average temperature since 1950.[1] Climate change—defined by the Federal Reserve as "the trend toward higher average global temperatures and accompanying environmental shifts such as rising sea levels and more severe weather events"—may impact multiple financial regulators' responsibilities, including those of ensuring financial stability.[2]

Risks from climate change may belong to the category of *physical risks*, such as heavier and more frequent storms or wildfires that impose direct losses. Or they may consist of *transition risk*, meaning the risk that changing government policies or market perceptions might lead to sudden asset price drops, such as for carbon-emitting industries. A 2020 report by the Commodity Futures Trading Commission (CFTC) found that climate change could pose systemic risks to the U.S. financial system.[3] The CFTC report concluded that, "in general, existing legislation already provides U.S. financial regulators with wide-ranging and flexible authorities that could be used to start addressing financial climate-related risk now," including the authority to address such risks in the realm of disclosure and investor protection, as well as risk management of particular markets and financial institutions.[4] Currently, however, the report found that "these authorities and tools are not being fully utilized to effectively monitor and manage climate risk."[5] The report concluded that further rulemaking—and in some cases legislation—may be necessary to ensure a coordinated national response to climate change risks.

The Financial Stability Oversight Council (FSOC)[6] has also reported that climate change poses financial risk to the United States. Congress created FSOC after the 2008 financial crisis to monitor risks to financial stability. It is chaired by the Treasury Secretary and consists of the heads of federal regulatory agencies, including the chair of the Securities and Exchange Commission (SEC) and the chairman of the Board of Governors of the Federal Reserve System. FSOC echoed the findings in the CFTC's earlier study in an October 2021 report, which identified climate change as an emerging threat to U.S. financial stability for the first time.[7] As

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[1] Donald J. Weubbles et al., *Climate Science Special Report: Fourth National Climate Assessment*, vol. I, USGCRP, 2017, at https://science2017.globalchange.gov/downloads/CSSR2017_FullReport.pdf. For more background, please see CRS Report R45086, *Evolving Assessments of Human and Natural Contributions to Climate Change*, by Jane A. Leggett.

[2] Board of Governors of the Federal Reserve System, *Financial Stability Report*, November, 2020, p. 58, at https://www.federalreserve.gov/publications/2020-november-financial-stability-report-near-term-risks.htm.

[3] U.S. Commodity Futures Trading Commission (CFTC) Commissioner Rostin Behnam, Sponsor, and Bob Litterman, Chairman, *Managing Climate Risks in the Financial Sector*, Report of the Climate-Related Market Risk Subcommittee, Market Risk Advisory Committee of the U.S. Commodity Futures Trading Commission, (2020), at https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf.

[4] CFTC Commissioner Behnam, *Managing Climate Risks in the Financial Sector*, p. 9.

[5] CFTC Commissioner Behnam, *Managing Climate Risks in the Financial Sector*, p. 9.

[6] FSOC, *Report on Climate-Related Financial Risk*, October 21, 2021, at https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf.

[7] Treasury Department, "FACT SHEET: The Financial Stability Oversight Council's Response to Climate-Related

part of its nonbinding recommendations, the report asked its member regulators to consider adoption of mandatory corporate public disclosures on climate-change-related risks by insurers, banks, and municipal bond issuers, among others. An additional recommendation was that its members use scenario analysis of potential risks attributed to global warming to identify potential areas of concern.[8]

On October 7, 2021, Federal Reserve Board (Fed) Governor Lael Brainard, whom President Biden has nominated to be the Fed's vice chair, spoke about climate change's risks to the economy. In the speech, Brainard stressed that physical risks from climate change were already inflicting damage on the economy and that future economic consequences from climate change could occur quickly in the presence of "tipping points."[9] She also noted that the total cost of U.S. weather and climate disasters over the past five years had exceeded $630 billion—a record amount for the United States—and that 2020 was the sixth year in a row that the United States had experienced 10 or more weather and climate disasters inflicting over $1 billion dollars in damage.[10]

The Securities and Exchange Commission's Role

The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.[11] As part of this mission, the SEC issued guidance in 2010 to assist publicly listed companies in evaluating when climate change risks require disclosure.[12] However, the 2020 CFTC report concluded that the 2010 SEC guidance has not resulted in high-quality disclosure of climate change risks across U.S. publicly listed firms, and that it should be updated in light of global advancements over the preceding 10 years.[13]

The amount of money involved in adequate disclosure of risks from climate change for equity investors is potentially large. The total market capitalization of the U.S. stock market at the end of 2020 was about $50.8 trillion.[14] Some studies have estimated the dollar risks from undisclosed climate-related risks to also be large. For instance, a 2019 survey of 215 of the largest global companies found those companies reported an estimated $1 trillion at risk from climate impacts, with many of those risks seen hitting within the next five years.[15] At the same time, a 2020

Financial Risk," press release, October 21, 2021, https://home.treasury.gov/system/files/136/FACT-SHEET-The-Financial-Stability-Oversight-Councils-Response-to-Climate-Related-Financial-Risk.pdf.

[8] FSOC, *Report on Climate-Related Financial Risk*.

[9] Federal Reserve Board Governor Lael Brainard, "Building Climate Scenario Analysis on the Foundations of Economic Research," remarks at the 2021 Federal Reserve Stress Testing Research Conference, Federal Reserve Bank of Boston, Boston, MA, October 7, 2021, https://www.federalreserve.gov/newsevents/speech/brainard20211007a.htm.

[10] Brainard, "Building Climate Scenario Analysis on the Foundations of Economic Research," citing damage estimates listed in years 2016 through 2020 in the National Oceanic and Atmospheric Administration's Billion-Dollar Weather and Climate Disasters database, available at https://www.ncdc.noaa.gov/billions/events.

[11] SEC, "About the SEC," at https://www.sec.gov/about.shtml#:~:text= The%20mission%20of%20the%20SEC,markets%3B%20and%20facilitate%20capital%20formation.

[12] SEC, "Commission Guidance Regarding Disclosure Related to Climate Change," 75 *Federal Register* 6290 (February 8, 2010), at https://www.federalregister.gov/documents/2010/02/08/2010-2602/commission-guidance-regarding-disclosure-related-to-climate-change.

[13] CFTC Commissioner Behnam, *Managing Climate Risks in the Financial Sector*, p. 11.

[14] This figure represents the total market capitalization of all U.S. based public companies listed on the New York Stock Exchange, Nasdaq Stock Market or OTCQX U.S. Market, according to "Total Market Value of U.S. Stock Market," Siblis Research, available at https://siblisresearch.com/data/us-stock-market-value/.

[15] "World's Biggest Companies Face $1 Trillion in Climate Change Risks," CDP, June 4, 2019, at https://www.cdp.net/

examination by a nonprofit group found that, on average, 42% of companies with a market capitalization over $10 billion disclosed various climate-risk related information, while the average was only 15% for companies with a market capitalization of less than $2.8 billion.[16] While the scale of investment appears large, views on the efficacy of the current level of disclosure related to climate risks are mixed.[17]

Two central questions are whether, and to what degree, emergent climate change risks are of material importance to investors, and to what degree current disclosures of climate change risks have been useful to investors.[18]

This report provides (1) an overview of the SEC's current guidance and standards for climate change risk disclosures; (2) an overview of the SEC's application of the "materiality" standard for disclosure of material risks under federal securities laws, and recent cases related to disclosure of climate change risks; (3) an analysis of whether and how the SEC is addressing climate change's impact on global supply chain risk; and (4) an analysis of the SEC's current regulation for investment management companies and environmental, social and governance (ESG) funds regarding climate change.

SEC Climate Change Disclosure Regime for Public Companies

Among other information, public companies generally must disclose developments, known trends, and uncertainties likely to have a *material impact* on the company's financial condition or operations through annual and periodic reporting. The Supreme Court has explained that a fact is "material" if there is a "substantial likelihood" that a reasonable shareholder would find it to significantly alter the total mix of available information.[19] (For more detail, see "A Closer Look at the Question: What Is a Material Risk?" below.) Such disclosures may contain information on climate-related risks. In July, 2021, SEC Chair Gary Gensler publicly called upon the SEC staff to propose a new rule or guidance that would update, and render more prescriptive (as opposed to principles-based), a 2010 guidance related to disclosure of climate risks, discussed below.[20]

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en/articles/media/worlds-biggest-companies-face-1-trillion-in-climate-change-risks.

[16] Task Force on Climate-Related Financial Disclosures, *2020 Annual Report*, October 2020, p. 4, at https://assets.bbhub.io/company/sites/60/2020/09/2020-TCFD_Status-Report.pdf.

[17] See, e.g., U.S. Government Accountability Office (GAO), *Climate Change Risks. SEC Has Taken Steps to Clarify Disclosure Requirements*, GAO-18-188, February 20, 2018, p. 15, at https://www.gao.gov/products/GAO-18-188.

[18] This includes the question of the usefulness of such disclosures both for investors seeking to assess risks for public companies and for investors in and portfolio managers of ESG funds.

[19] See Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

[20] SEC Chairman Gary Gensler, "Prepared Remarks Before the Principles for Responsible Investment 'Climate and Global Financial Markets,'" July 28, 2021, https://www.sec.gov/news/speech/gensler-pri-2021-07-28. More recently, news reports stated that a rift among SEC commissioners over how closely to adhere to established legal standards on the materiality of various climate disclosures had delayed the rule's release. See Robert Schmidt and Benjamin Bain, "SEC Bogs Down on Climate Rule, Handing White House Fresh Setback," *Bloomberg News*, February 8, 2022, https://www.bloomberg.com/news/articles/2022-02-08/sec-bogs-down-on-climate-rule-saddling-biden-team-with-new-woe.

The 2010 SEC Climate Change Guidance

In 2010, the SEC issued "Guidance Regarding Disclosure Related to Climate Change" (the Guidance) to give added insight into how the existing disclosure requirements for SEC reporting companies are applicable to matters related to climate change.[21] When the Guidance was issued, then-SEC Chair Mary Schapiro said

> An interpretive release, as this is known, does not create new legal requirements or modify existing ones—it is merely intended to provide clarity and enhance consistency. To that end, the Commission is not making any kind of statement regarding the facts as they relate to the topic of "climate change" or "global warming." And, we are not opining on whether the world's climate is changing; at what pace it might be changing; or due to what causes. Nothing that the Commission does today should be construed as weighing in on those topics.[22]

Since then, the Guidance has been central to agency policy on corporate reporting on climate-related risks.[23] Specifically, the Guidance states what companies could be required to disclose in relation to climate change under the corporate disclosure requirements that fall under the SEC's Regulation S-K under the Securities Act of 1933 (P.L. 73-22), which provides the basis for the overall corporate disclosure regime. Among them are Form 10-K filings[24]—and within those, particularly commentary in the risk factors section of the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).[25]

In part, the Guidance attempts to clarify how certain climate-change-related matters should be disclosed under the aforementioned SEC corporate disclosures through providing examples of developments that could trigger such disclosures. Key points expressed in the Guidance include the need to disclose, if material

- the impact of climate change legislation and regulation;
- the impact of international accords on climate change;
- climate change-based disruptions in supply chains;
- indirect consequences of regulation or business trends; and
- physical impacts of climate change.[26]

[21] SEC, "Commission Guidance Regarding Disclosure Related to Climate Change," 75 *Federal Register* 6290 (February 8, 2010), at https://www.federalregister.gov/documents/2010/02/08/2010-2602/commission-guidance-regarding-disclosure-related-to-climate-change.

[22] Statement by SEC Chairman Mary Schapiro, "Before the Open Commission Meeting on Disclosure Related to Business or Legislative Events on the Issue of Climate Change," January 27, 2010, at https://www.sec.gov/news/speech/2010/spch012710mls-climate.htm.

[23] See, e.g., SEC Chairman Jay Clayton, "Statement on Proposed Amendments to Modernize and Enhance Financial Disclosures; Other Ongoing Disclosure Modernization Initiatives; Impact of the Coronavirus; Environmental and Climate-Related Disclosure, Securities and Exchange Commission," January 30, 2020, at https://www.sec.gov/news/public-statement/clayton-mda-2020-01-30.

[24] A 10-K is a comprehensive summary report of a company's performance that must be submitted annually to the SEC. Typically, the 10-K contains much more detail than the annual report to shareholders does.

[25] MD&A involves textual discussion of a company's operations and financial results, including information on any known trends or uncertainties that can materially affect those financial results. It may also contain management's views of key business risks and actions to address them.

[26] SEC, "Commission Guidance," pp. 6289-6291.

While the Guidance is central to agency policy on corporate reporting on climate-related risks, SEC senior staff told the Government Accountability Office (GAO) in 2018 that they had no expectations that the Guidance would result in changes to companies' climate-related disclosures because the Guidance did not involve new disclosure requirements.[27]

In January 2020, then-SEC Chairman Jay Clayton observed that companies had made "robust efforts" to comply with the climate-related disclosure regime. However, he also noted that in certain instances, SEC staff "has issued comments questioning the sufficiency and consistency of the disclosures."[28]

In June 2020 commentary to the SEC, Ceres, a nonprofit organization that gives advice on sustainability to companies and investors, observed that on the SEC website there were "only three comment letters from the SEC staff mentioning climate change during Chairman Clayton's tenure." It also noted that in the past four years, "only six SEC comment letters mentioned climate change" and that "SEC leadership and staff have, in the past, made a much stronger effort to ensure companies followed the Guidance." Ceres then noted that "in 2010 and 2011, the SEC staff sent 49 comment letters to issuers encouraging better disclosure on climate-related matters."[29]

In addition, Ceres argued that "there is a disconnect between Chairman Clayton's statement that SEC staff has generally found robust efforts to comply with the disclosure requirements and evidence about the quality of climate-related disclosure by issuers."[30] It then cited research by the National Association of Corporate Directors, an association of corporate board members, which found that while 30% of companies in the Russell 3000 stock index discussed climate change as a risk factor in their 10-K filings, only 3% discussed climate risks in their critical Management Discussion and Analysis (MD&A) commentary.[31]

A 2018 GAO report examined the steps taken by the SEC to aid companies' understanding of the disclosure regime for climate-related risks.[32] Among other things, it found that companies report similar climate-related disclosures in different sections of the annual filings. It also observed that some filings had climate-related disclosures that used boilerplate language that was not company-specific and thus lacked quantification.[33]

On February 24, 2021, Acting SEC Chair Allison Herren Lee observed that "[n]ow more than ever, investors are considering climate-related issues when making their investment decisions. [And] [i]t is our responsibility to ensure that they have access to material information when planning for their financial future." As part of this, in February 2021, she said that she was directing the Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings, including, reviewing "the extent to which public companies address

[27] GAO, *Climate Change Risks. SEC Has Taken Steps to Clarify Disclosure Requirements*, GAO-18-188, February 20, 2018, p. 15, at https://www.gao.gov/products/GAO-18-188.

[28] SEC Chairman Jay Clayton, "Statement on Proposed Amendments to Modernize and Enhance Financial Disclosures."

[29] Ceres, *SEC Request for Comments on Fund Names*, May 5, 2020, at https://www.sec.gov/comments/s7-04-20/s70420.htm.

[30] Ceres, *SEC Request for Comments on Fund Names*.

[31] Leah Rozin, "ESG Risks Trickle Into Financial Filings," National Association of Corporate Directors, October 21, 2019, at https://blog.nacdonline.org/posts/esg-risks-trickle-into-financial-filings.

[32] GAO, *Climate Change Risks*, pp. 16-17

[33] GAO, *Climate Change Risks*, pp. 17-18.

the topics identified in the 2010 guidance."[34] As part of this, she indicated that the SEC staff would be drawing on insights from that work to start updating the 2010 guidance to reflect "developments in the last decade."[35]

In March 2021, on the heels of that announcement, Lee also said that she was requesting public input from "investors, registrants, and other market participants" on "whether current disclosures adequately inform investors."[36] As part of this, 15 questions were posed for consideration, including, "How can the Commission best regulate, monitor, review, and guide climate change disclosures in order to provide more consistent, comparable, and reliable information for investors while also providing greater clarity to registrants as to what is expected of them?" "What information related to climate risks can be quantified and measured?" "How are markets currently using quantified information?" "What are the advantages and disadvantages of establishing different climate change reporting standards for different industries, such as the financial sector, oil and gas, transportation, etc.?" and "What is the best approach for requiring climate-related disclosures? For example, should any such disclosures be incorporated into existing rules such as Regulation S-K or Regulation S-X, or should a new regulation devoted entirely to climate risks, opportunities, and impacts be promulgated? Should any such disclosures be filed with or furnished to the Commission?"[37]

In 2021, the SEC announced other related developments:

- On February 1, 2021, the SEC announced that it had created and was filling a new position, the Senior Policy Advisor for Climate and ESG in the office of Acting Chair Allison Herren Lee. The role involves advising the agency on environmental, social, and governance matters and advance related to new initiatives across offices and divisions.[38]
- On March 4, 2021, the agency announced the establishment of a Climate and ESG Task Force within its Division of Enforcement. Generally, the task force will coordinate the utilization of SEC resources, via processes such as data analytics, to assess registrant information. In addition, it will identify material gaps or misstatements in issuers' disclosures of climate-related risks under the current regulations.[39]

[34] Acting SEC Commissioner Allison Herren Lee, "Statement on the Review of Climate-Related Disclosure," February 24, 2021, at https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure.

[35] Herren Lee, "Statement on the Review of Climate-Related Disclosure."

[36] Acting SEC Commissioner Allison Herren Lee, "Public Input Welcomed on Climate Change Disclosures,' March 15, 2021, at https://www.sec.gov/news/public-statement/lee-climate-change-disclosures.

[37] Herren Lee, "Public Input Welcomed on Climate Change Disclosures."

[38] SEC, "Satyam Khanna Named Senior Policy Advisor for Climate and ESG," press release, February 1, 2021, at https://www.sec.gov/news/press-release/2021-20.

[39] SEC, "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues," press release, March 4, 2021, at https://www.sec.gov/news/press-release/2021-42. In a joint statement, Republican Commissioners Elad Roisman and Hester Peirce, however, pushed back on the initiative: "[S]houldn't we wait for our Corporation Finance staff to complete its assessment of our existing rules relating to ESG disclosures to find out if they are unclear or in need of updating before we announce an initiative aimed at bringing enforcement actions in this area?" SEC Commissioner Elad Roisman and SEC Commissioner Hester Peirce, "Enhancing Focus on the SEC's Enhanced Climate Change Efforts," March 4, 2021, at https://www.sec.gov/news/public-statement/roisman-peirce-sec-focus-climate-change.

Principles-Based vs. Prescriptive Climate-Related Disclosure

Jay Clayton, an independent appointed by President Donald Trump who departed the SEC as chairman at the end of 2020, described the prevailing approach to issuer disclosure of climate risks as requiring companies to provide appropriate and timely disclosure of known trends and other information that they deem to be material to a firm's future operations. As chair, he argued that such factors tend to be "very company-specific and sector-specific."[40] As a result, the disclosure regime avoided imposing a uniform climate risk disclosure regime across all industries. As part of this, the former chairman emphasized that climate risks have disparate impacts that can vary with a particular industry. For example, he argued that property and casualty insurers are more sensitive to environmental damage than are many other industries and that disclosure policies should be suitably flexible to account for such variations.[41]

Two Democratic SEC commissioners, Allison Herren Lee and Caroline Crenshaw, have expressed a different view on the preferred approach to climate risk disclosure, as described below.

In August 2020, the SEC adopted amendments to Regulation S-K under the Securities Act of 1933. Significantly, under the adopted reform, disclosure requirements for a company's human capital were enhanced.[42] Commissioners Crenshaw and Lee voted against the reform in part because, in their view, it failed to satisfactorily address climate risk disclosure.[43] In a joint statement on their opposition to the Regulation S-K final rule, the two dissenters described their preferred approach to climate risk disclosure as a more uniform and standardized and less principles-based protocol. Among other things, they argued that while the principles-based approach has led many firms to make some climate risk disclosures, many of them fail to do so. Commissioners Crenshaw and Lee also noted that the "majority of U.S. based large companies have failed to acknowledge the financial risks of climate change in their filings…. When disclosure metrics are not uniform and standardized the task of pricing and comparing these risks and opportunities is, at best, unduly burdensome. And without specific requirements, much of the information is simply not there to be worked into the analysis."[44] The two commissioners also said that they were encouraged by the fact that the SEC has "an opportunity going forward to address climate, human capital, and other ESG risks, in a comprehensive fashion with new rulemaking specific to these topics."[45]

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[40] As reported in Tom Zanki, "SEC Chair Says Climate Disclosures Aren't One-Size-Fits-All," *Law 360*, November 19, 2020, at https://www.law360.com/articles/1330459/sec-chair-says-climate-disclosures-aren-t-one-size-fits-all.

[41] See, e.g., SEC Chairman Jay Clayton, "Statement on Proposed Amendments to Modernize and Enhance Financial Disclosures," and reporting in Tom Zanki, "SEC Chair Says Climate Disclosures Aren't One Size Fits," *Law360*, November 19, 2020, at https://www.law360.com/articles/1330459/sec-chair-says-climate-disclosures-aren-t-one-size-fits-all.

[42] SEC, "SEC Adopts Rule Amendments to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors Under Regulation S-K," press release, August 26, 2020, at https://www.sec.gov/news/press-release/2020-192.

[43] SEC Commissioners Allison Herren Lee and Caroline Crenshaw, "Joint Statement on Amendments to Regulation S-K: Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information," November 19, 2020, at https://www.sec.gov/news/public-statement/lee-crenshaw-statement-amendments-regulation-s-k.

[44] SEC Commissioners Allison Herren Lee and Caroline Crenshaw, "Joint Statement on Amendments to Regulation S-K: Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information."

[45] SEC Commissioners Allison Herren Lee and Caroline Crenshaw, "Joint Statement on Amendments to Regulation S-K: Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information."

In March 2021, Commissioners Peirce and Roisman injected a cautious note on the prospects of a more prescriptive climate risk disclosure regime superseding the existing principles-based one. They argued that this was because the aforementioned initiative to update the 2010 guidance will not in itself lead to the adoption of a prescriptive disclosure protocol since such a change would require a vote by the commissioners.[46]

President Joseph Biden nominated Gary Gensler to be SEC chair, and he was confirmed by the Senate on April 14, 2021. Mr. Gensler is a third Democratic commissioner alongside the two Republican commissioners, Elad Roisman and Hester Peirce. During his nomination hearing before the Senate Committee on Banking, Housing, and Urban Affairs, Mr. Gensler appeared to indicate an interest in a more discrete and prescriptive rule-based climate-related disclosures: "Increasingly, investors really want to see – tens of trillions of dollars in assets behind it – climate risk disclosure. Issuers would benefit from such guidance. So, I think through good economic analysis, working with the staff, putting out to the public to get public feedback that is something the commission, if I'm confirmed, would work on."[47]

Remarks by Chair Gensler on July 28, 2021, gave a potential move in a prescriptive direction further impetus. In the remarks, he indicated that things had changed since the 2010 guidance and asserted that investors are not able to compare corporate climate-related disclosures in a way that they find useful. He also said that three-fourths of the responses to Commissioner Lee's earlier request for input on climate-related disclosures had advocated for mandatory climate disclosure rules. Notably, he said, "I believe the SEC should step in when there's this level of demand for information relevant to investors' decisions." He then indicated that he had asked the SEC staff to "develop a mandatory climate risk disclosure rule proposal for the Commission's consideration by the end of the year."[48] In subsequent statements, the chairman reportedly indicated that the proposal could be issued in 2022.[49] In response to questions at a hearing on October 5, 2021, before the House Financial Services Committee, Chair Gensler commented that as part of the SEC's forthcoming climate-change-related disclosure regime, he had asked SEC staff to consider a phased-in implementation approach for smaller versus larger public companies and tiered reporting time frame for different types of climate-related disclosures.[50]

Other observers, including SEC Commissioner Hester Peirce, have criticized such agency efforts. She observed

> The Commission has looked to materiality as our guiding principle when crafting disclosure requirements because it is an objective standard by which we can exercise our statutory authority to decide what is necessary or appropriate in the public interest or for the protection of investors…. Mandating that issuers provide … [investors] with information that does not contribute to assessing the prospect for investment returns costs them in, among other things, bills for lawyers and consultants to prepare the disclosures;

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

[47] "Senate Banking, Housing and Urban Affairs Committee Holds Hearing on Pending Nominations CQ Congressional Transcripts," *CQ Transcripts*, March 2, 2021, at https://plus.cq.com/doc/congressionaltranscripts-6146050?3.

[48] Gensler, "Prepared Remarks Before the Principles for Responsible Investment 'Climate and Global Financial Markets.'"

[49] Jim Tyson, "SEC Asks Companies for Details on Impact of Climate Change," *CFO Dive*, September, 23, 2021, at https://www.cfodive.com/news/sec-asks-companies-details-impact-climate-change/607096/.

[50] "House Financial Services Committee Holds Hearing on Securities and Exchange Commission," *CQ Congressional Transcripts*, October 5, 2021, at https://plus.cq.com/doc/congressionaltranscripts-6359065?4.

> employee, management, and board time and attention; and potential litigation expenses. Why would we want to impose these costs on shareholders without providing them with the offsetting benefit of material information?[51]

Similarly, among the responses to Commissioner Lee's request was a letter from Republican members of the Senate Banking, Housing, and Urban Affairs Committee: Senators Pat Toomey, Richard Shelby, Mike Crapo, Tim Scott, Mike Rounds, Thom Tillis, John Kennedy, Bill Hagerty, Cynthia Lummis, Kevin Cramer, Steve Daines, and Jerry Moran. The letter stated: "We do not believe that any further securities regulations to specifically address global warming are necessary or appropriate, and will only serve to further discourage firms from becoming publicly traded, thus denying significant investment opportunities to retail investors.[52]

A Closer Look at the Question: What Is a Material Risk?

Federal securities law does not explicitly require disclosure of specific climate-related risks.[53] However, as discussed in the SEC's 2010 Guidance, a public company may need to disclose climate-related risks that are "material" to investors.[54] Generally, publicly traded companies must disclose certain information, such as financial statements and other business information specified by SEC regulations, in their periodic filings.[55] SEC regulations also require disclosure of "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."[56] However, absent a duty to disclose, such as that created by the above-referenced regulations, there is no *per se* obligation to disclose all material information.[57]

The "Materiality" Standard Generally

The U.S. Supreme Court has defined a material fact as follows: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[58] In other words, the Court explained, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[59] The test

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[51] SEC Commissioner Hester Peirce, "Chocolate-Covered Cicadas," July 20, 2021, at https://www.sec.gov/news/speech/peirce-chocolate-covered-cicadas-07202.1

[52] Letter to the Honorable Gary Gensler and the Honorable Allison Herren Lee, Commissioner, "Re: Public Input on Climate Change Disclosures," June 13, 2021, at https://www.sec.gov/comments/climate-disclosure/cll12-8911330-244285.pdf.

[53] See CRS In Focus IF11307, *Climate-Related Risk Disclosure Under U.S. Securities Laws*, by Eva Su and Nicole Vanatko; Securities and Exchange Commission, *Commission Guidance Regarding Disclosure Related to Climate Change*, 75 *Federal Register* 6290 (February 8, 2010).

[54] See 17 C.F.R. §§240.10b-5, 240.12b-20.

[55] Ibid., Parts 210, 229.

[56] Ibid. §240.12b-20.

[57] See, e.g., Thomas Lee Hazen, *Treatise on the Law of Securities Regulation*, vol. 3, §12.60.

[58] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). *TSC* arose in the context of whether proxy solicitation materials provided to shareholders before voting on a merger omitted material information under Section 14 of the Securities Exchange Act. Ibid., pp. 441-442.

[59] Ibid. In 1988, in *Basic v. Levinson*, the Supreme Court expressly adopted *TSC*'s definition of materiality for evaluating alleged misstatements or omissions in the context of the act's anti-fraud provisions, which apply more

for materiality is an objective one using the reasonable investor as its reference point.[60] Therefore, the fact that an investor subjectively considered something important, or that a reasonable investor would find the information to be *of interest*, is not sufficient.[61] Courts have explained that the "total mix" of information refers to the "sum of all information reasonably available" to investors.[62] Courts and the SEC make materiality determinations on a case-by-case basis, using a principles-based approach rather than prescribing bright-line rules.[63] As such, courts have not identified a quantitative threshold for the impact of a misstatement or omission in order to make it material.[64] Even so, the SEC's default position is that the materiality standard should be understood in terms of the information's economic or financial impact.[65]

Climate Risk Disclosure Cases

While courts have at times assessed the materiality of environmental or safety information in relation to events such as environmental accidents,[66] relatively few decisions have specifically analyzed the materiality of a company's disclosures concerning the impacts of climate change.[67] However, in two relatively recent cases, courts analyzed the materiality of Exxon Mobil Corporation's (Exxon's) disclosures and omissions relating to its "proxy cost of carbon"

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broadly to investors' decisions to purchase or sell securities. 485 U.S. 224, 231-32 (1988).

[60] *TSC*, 426 U.S. at 445; see Hazen, *Treatise on the Law of Securities Regulation*, §12.60.

[61] See Hazen, *Treatise on the Law of Securities Regulation*, §§12.60, 12.62; see e.g., United States v. Litvak, 889 F.3d 56, 65 (2d Cir. 2018) (testimony regarding traders' "own point of view" was relevant only insofar as it was "shown to be within the parameters of the thinking of reasonable investors in the particular market at issue"); Resnik v. Swartz, 303 F.3d 147, 154 (2d Cir. 2002) ("Disclosure of ... information is not required ... simply because it may be relevant or of interest to a reasonable investor.").

[62] Koppel v. 4987 Corp., 167 F.3d 125, 132 (2d Cir. 1999) (internal quotation marks omitted); see, e.g., Ieradi v. Mylan Labs., Inc., 230 F.3d 594, 599-600 (3d Cir. 2000) (failure to disclose exclusive supply contracts was not material when company disclosed in its 10-Q that it was the subject of FTC investigation for anti-competitive activity).

[63] See Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 38-39 (2011) (declining to adopt plaintiff's bright-line test for materiality and stating that "[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive") (quoting *Basic*, 485 U.S. at 236)).

[64] See, e.g., Hazen, *Treatise on the Law of Securities Regulation*, §12.74. In some cases, however, courts have used the absence of stock price movement as evidence of immateriality. See, e.g., In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1425 (3d Cir. 1997) ("Because the market for BCF stock was 'efficient' [(one in which information important to reasonable investors is immediately incorporated into stock prices)] and because the … disclosure had no effect on BCF's price, it follows that the information … was immaterial.").

In 1999, the SEC further rejected a numerical threshold approach in a staff bulletin (referred to as "SAB 99") regarding accounting irregularities in financial statements, although it stated that a 5% "rule of thumb" may serve as preliminary guidance to an issuer in the absence of egregious circumstances. SEC, Staff Accounting Bulletin No. 99—Materiality, Release No. SAB 99, 1999 WL 1123073, at *2 (Aug. 12, 1999) [hereinafter "SAB 99"].

[65] See, e.g., Ruth Jebe, "The Convergence of Financial and ESG Materiality: Taking Sustainability Mainstream," *American Business Law Journal*, vol. 56, pp. 645, 660 (2019) ("[T]he SEC has consistently interpreted materiality to mean economic materiality."); but see In re Franchard Corp., 42 S.E.C. 163, 174 (1964) (finding information relating to the ethical quality of top corporate officials to be material).

SAB 99, however, does provide guidance regarding "qualitative factors" that may affect materiality even if a misstatement's quantitative impact is small—for example, whether the misstatement concerns a line of business that the company has identified as significant, affects regulatory compliance, or conceals illegal activity. *SAB 99*, 1999 WL 1123073, at *3-4.

[66] See, e.g., In re BP P.L.C. Sec. Litig., 922 F. Supp. 2d 600, 609, 640-41 (S.D. Tex. 2013) (holding that plaintiffs sufficiently alleged securities fraud claims with respect to several misstatements regarding safety measures).

[67] See, e.g., Hana V. Vizcarra, "The Reasonable Investor and Climate-Related Information: Changing Expectations for Financial Disclosures," *Environmental Law Reporter News and Analysis* (ELR), vol. 50, pp. 10106, 10112 (2020).

measure—a metric which, in this situation, approximates the cost of potential government-related climate change actions (i.e., certain transition risks) in financial projections.[68] In each of the cases, the plaintiff alleged that Exxon's public disclosures of its proxy cost of carbon were materially misleading because they differed from some of Exxon's *internal* estimates of the relevant costs.[69] The courts, opining at different stages of the litigation process, reached disparate results as to the misstatements' and omissions' materiality.

In a 2018 decision, *Ramirez v. Exxon Mobil Corp.*, the U.S. District Court for the Northern District of Texas declined to dismiss the action, holding that plaintiffs had adequately alleged securities fraud.[70] As to materiality, the court ruled that a "reasonable investor would likely find it significant that ExxonMobil allegedly applied a lower proxy cost of carbon than it publicly disclosed,"[71] and that investors may have been materially misled because "ExxonMobil's public statements allegedly indicate to investors only one proxy cost value was used across all business units in making investment decisions."[72]

However, in December 2019, Exxon prevailed at trial in a New York state trial court in an action based on similar allegations.[73] As in *Ramirez*, the complaint alleged that because Exxon did not incorporate proxy costs of carbon in its internal decision-making in the manner it represented, its financial vulnerability to climate change regulation was significantly greater than it led investors to believe.[74] Nonetheless, the court, in an unpublished decision, found that there was no proof that Exxon's use of two different figures affected "its balance sheet, income statement, or any other financial disclosure," and that the eventual disclosure of the two different figures "was essentially ignored by investors."[75] Citing the complex, evolving regulatory environment, the court ruled that "no reasonable investor would have viewed speculative assumptions about hypothetical regulatory costs projected decades into the future as 'significantly alter[ing] the total mix of information made available.'"[76]

Example: Material Supply Chain Risks from Climate Change

The Coronavirus Disease 2019 (COVID-19) pandemic has recently highlighted the significance of supply chain disruption risks for publicly listed companies in ways that may also be of concern from a climate change perspective. Similarly, some have questioned whether the risks to companies' supply chains from potentially increasing climate change effects are adequately

[68] Ramirez v. Exxon Mobil Corp., 334 F. Supp. 3d 832, 846 (N.D. Tex. 2018); People v. Exxon Mobil Corp., No. 452044/2018, 2019 WL 6795771 (N.Y. Sup. Ct. Dec. 10, 2019).

[69] *Ramirez*, 334 F. Supp. 3d at 839-40, 846; *People*, 2019 WL 6795771, at *4-5, 12-16.

[70] *Ramirez*, 334 F. Supp. 3d at 839.

[71] Ibid. at 846.

[72] Ibid.

[73] The New York Supreme Court December 2019 decision involved claims brought under New York's Martin Act, rather than the federal securities laws. Martin Act, N.Y. Gen. Bus. Law. §352. However, New York has adopted the federal standard of materiality in securities fraud cases brought under the Martin Act. *People*, 2019 WL 6795771, at *3.

[74] *People*, 2019 WL 6795771, at *15.

[75] Ibid. at *20.

[76] Ibid. (citations omitted).

disclosed to investors.[77] The potential for supply chain disruptions has long been considered information that may be material for investors.[78]

Broadly speaking, a "supply chain" refers to suppliers providing goods, services and other materials needed for a company to operate. Supply chains encompass both a company's immediate supply base, through suppliers it directly interacts with, and its indirect suppliers.[79] For instance, a supply chain for canned beverage companies would usually include metal can manufacturers and also the relevant metal mining companies. Potential climate-change-related risks to supply chains include both *chronic risks*, such as chronic water supply shortages or water quality issues, and *acute risks*, such as sudden disruptions due to storms, wildfires, or other unexpected events.

A recent McKinsey report found that supply chains are already being disrupted by extreme weather and that this risk will continue to increase with climate change.[80] For example, it noted that supply chains for the $400 billion semiconductor manufacturing industry are heavily concentrated in facilities in southern Japan, Korea, Taiwan, and elsewhere in the Western Pacific, where hurricanes sufficient to disrupt such manufacturing operations are estimated to become two to four times more likely by 2040.[81] These potential disruptions have implications for a wide range of critical industries, from military technology, healthcare, transportation, and clean energy production, to consumer goods like computers and smartphones. Additional reports have also concluded that such risks and disruptions are likely to increase in the future because of climate change.[82]

As noted above, the SEC's 2010 climate change guidance expressly notes that potential supply chain disruptions due to climate change may be material to investors. That said, however, a 2016 GAO report on disclosure of supply chain risks following the SEC's guidance found that, "According to SEC staff, it is difficult for SEC reviewers to know whether a company faces a material climate-related supply chain risk that it is not disclosing."[83] The 2016 GAO report also found that the SEC did not have a subject-matter expert for climate-related issues, because

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[77] See Christy Slay and Kevin Dooley, *Improving Supply Chain Resilience to Manage Climate Change Risks*, The Sustainability Consortium, with funding from HSBC, June 2020, at https://www.sustainablefinance.hsbc.com/-/media/gbm/sustainable/attachments/supply-chain-resilience-and-climate-change.pdf. See also SEC Commissioner Allison Herren Lee, "'Modernizing' Regulation S-K: Ignoring the Elephant in the Room," public statement, January 30, 2020, at https://www.sec.gov/news/public-statement/lee-mda-2020-01-30.

[78] See Chonnikarn Fern Jira, and Michael W Toffel, *Engaging Supply Chains in Climate Change*, Harvard Business School Technology and Operations Management Unit, Working Paper no. 12-026, October 12, 2012, available at https://ssrn.com/abstract=1943690 or http://dx.doi.org/10.2139/ssrn.1943690.

[79] See Dr. Christy Slay and Dr. Kevin Dooley, *Improving Supply Chain Resilience to Manage Climate Change Risks*.

[80] McKinsey Global Institute, *Could Climate Change Become the Weak Link in Your Supply Chain?* Case Study, August 2020, at p. 10.

[81] McKinsey Global Institute report citing Woods Hole Research Center analysis based on Kerry Emanuel, The Coupled Hurricane Intensity Prediction System (CHIPS), Massachusetts Institute of Technology, 2019; Water and Climate Resilience Center, RAND Corporation. *See* McKinsey report, footnote 7, p. 10: "While total hurricane frequency is expected to remain unchanged or to decrease slightly under increased global warming, cumulative hurricane rainfall rates, average intensity, and proportion of storms that reach Category 4 or 5 intensity are projected to rise, even for an increase of two degrees Celsius or less in global average temperatures." Thomas Knutson et al., "Tropical cyclones and climate change assessment: Part II. Projected response to anthropogenic warming," *Bulletin of the American Meteorological Society*, 2019.

[82] Dr. Christy Slay and Dr. Kevin Dooley, *Improving Supply Chain Resilience to Manage Climate Change Risks*, p. 5.

[83] GAO, *Supply Chain Risk: SEC's Plans to Determine If Additional Action Is Needed on Climate-Related Disclosure Have Evolved*, GAO-16-211, January 2016, p. 18, at https://www.gao.gov/assets/680/674845.pdf. (Hereinafter, GAO, *Supply Chain Risk.*)

"disclosures of climate-related matters in SEC filings do not require technical expertise to understand," according to SEC staff[84] and that the Division of Enforcement had not filed any actions concerning climate-related disclosure issues.[85] Overall, the 2016 GAO report appeared to find a wide variety in whether and how companies disclosed any climate-changed related supply risks, but the report did not explicitly characterize the overall quality of disclosure.

Broadly speaking, calls from investors, advocates, and from SEC Commissioners themselves have been mounting for the SEC to set out more explicit guidelines for companies to disclose material risks related to climate change, such as potential supply chain disruptions and other risks.[86] A March 25, 2020, guidance from the SEC's Division of Corporation Finance noted that "questions to consider" for companies in their investor disclosures include "Do you anticipate a material adverse impact of COVID-19 on your supply chain or the methods used to distribute your products or services?"[87] The guidance noted, however, that it had "no legal force or effect" and "creates no new or additional obligations for any person."[88] Pressure appears to be growing on the SEC to look more closely at its standards for disclosures to investors with regards to climate change risks, and related specificity and consistency.

SEC Requirements for Investment Managers Regarding Climate Change Disclosures

Environmental, social, and governance (ESG) funds are portfolios of equities and/or bonds, typically in the form of mutual funds, for which environmental, social, and governance factors have been integrated into the investment process. Investor interest in such funds has grown significantly over the years. For example, in 2020, according to Morningstar, the mutual fund researcher, ESG mutual funds received $51.1 billion of net new funding from investors in 2020. That reportedly represented the fifth consecutive annual increase, and more than double the $21 billion in 2019.[89] The aforementioned October 2021 FSOC report noted that total U.S. assets invested under ESG strategies had grown to $17.1 trillion—equivalent to 33% of total assets managed.[90]

The SEC's Division of Investment Management has primary responsibility for administering the Investment Company Act of 1940[91] (15 U.S.C. §§ 80-1 et seq.) and the Investment Advisers Act

[84] GAO, *Supply Chain Risk*, p. 17.

[85] GAO, *Supply Chain Risk*, p. 19.

[86] SEC Commissioner Allison Herren Lee, "'Modernizing' Regulation S-K: Ignoring the Elephant in the Room," January 30, 2020, at https://www.sec.gov/news/public-statement/lee-mda-2020-01-30.

[87] SEC Division of Corporation Finance, *COVID-19 Guidance*. The division noted however that "the statements in this CF Disclosure Guidance represent the views of the Division of Corporation Finance. This guidance is not a rule, regulation, or statement of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved its content. This guidance, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person."

[88] SEC Division of Corporation Finance, *COVID-19 Guidance*.

[89] Greg Iacurci, "Money Invested in ESG Funds More Than Doubles in a Year," *CNBC*, February 11, 2021, at https://www.cnbc.com/2021/02/11/sustainable-investment-funds-more-than-doubled-in-2020-.html.

[90] FSOC report, 2021, p. 75, citing US SIF, "2020 Report on US Sustainable and Impact Investing Trends," at https://www.ussif.org/files/Trends/2020_Trends_Onepager_Alternatives.pdf.

[91] 15 U.S.C. §80-1 et seq.

of 1940[92] (15 U.S.C. §§ 80b-1 et seq.), which include developing regulatory policy for investment companies (such as mutual funds, money market mutual funds, closed-end funds, business development companies, unit investment trusts, variable insurance products, and exchange-traded funds) and for investment advisers.[93]

As is the case with its approach to reporting companies, the SEC does not have rules, regulations, or requirements that specifically govern investment companies'[94] or investment advisers' use of ESG principles or their disclosures of ESG-related strategies that may impact climate change. There is no universally agreed-upon, or legally binding, definition of what constitutes ESG, or an ESG fund.[95] In recent years, funds marketed to investors as "ESG" have grown markedly in terms of assets under management. Morningstar, which follows fund developments, reportedly found that at the end of the third quarter of 2020, assets under management at "sustainable" domestic funds were $179 billion.[96] Globally, over 3,000 signatories—with over $103 trillion in assets under management—support Principles for Responsible Investment, a nongovernmental organization that promotes sustainability through ESG.[97] While no standardized requirements currently exist for such ESG funds' investments, there are certain fundamental regulations within the federal securities laws that have an *indirect* impact on ESG disclosure-related practices.

For example, if an investment company's manager, an SEC-registered investment adviser, incorporates ESG principles as a primary investment strategy, disclosure of the strategies and risks associated with them must be in the investment company's registration statements under the Investment Company Act of 1940. In addition, Rule 35d-1, the fund name rule, under the act requires that at least 80% of the assets of an SEC-registered investment company with a name suggesting it focuses on a particular type of investment must be invested in that type of investment. According to some reporting, historically, the SEC staff has frequently taken an approach in which terms like "ESG" or "sustainable" in a fund name were deemed to have triggered the requirement.[98]

The aforementioned ESG Task Force will also analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.[99]

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[92] 15 U.S.C. §80b-1 et seq.

[93] SEC, "Division of Investment Management," at https://www.sec.gov/investment/Article/investment_about.html.

[94] An investment company is a corporation or trust engaged in the business of investing the pooled capital of investors in financial securities. Typically, this is either done through a closed-end fund or an open-end fund (also referred to as a mutual fund).

[95] David M. Silk, David A. Katz, and Sabastian V. Niles, "U.K. and EU Regulators Move Ahead on ESG Disclosures and Benchmarks," *Harvard Law School Forum on Corporate Governance*, April 26, 2020, at https://corpgov.law.harvard.edu/2020/04/26/u-k-and-eu-regulators-move-ahead-on-esg-disclosures-and-benchmarks/.

[96] Leslie P. Norton, "Sustainable-Fund Assets Hit $1.2 Trillion as ESG Continues to Gain Market Share," *Barron's*, October 29, 2020, at https://www.barrons.com/articles/sustainable-fund-assets-hit-record-esg-continues-to-gain-market-share-51603993554.

[97] Its website is at https://www.unpri.org/.

[98] The Dechert Law Firm, *Expectations Under the Biden Administration: The ESG and Diversity/Inclusion Outlook for Reporting Companies and Asset Managers*, January 2021, at https://info.dechert.com/10/14950/january-2021/expectations-under-the-biden-administration—the-esg-and-diversity-inclusion-outlook-for-reporting-companies-and-asset-managers.asp?sid=fcb51fd2-aca2-42d2-a501-686f2490c68f.

[99] SEC, "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues," press release, March 4, 2021, at https://www.sec.gov/news/press-release/2021-42.

Potential Ambiguity in Climate-Friendly Fund Labels

There has reportedly been a proliferation of purportedly "climate-friendly" investment companies.[100] SEC Commissioner Elad Roisman asserts that growth has been accompanied by managers who often have labeled such funds as "ESG, Green, or Sustainable … while there is no universal definition for any of these terms, and such products' investment philosophies and holdings can differ widely."[101] Relatedly, in March 2020, the SEC staff issued a request for comment that solicited public commentary on whether the requirements are effective for fund names, including funds that contain terms such as *ESG* or *sustainable* under Rule 35d-1, and help to ensure that investors are not misled by the name. In the ESG fund sphere, a major concern is whether an ESG label refers to a "strategy" or a "specific type of investment."[102]

In July 2021, within the context of the possible expansion of public company climate-related disclosures, Chair Gensler noted the absence of a "standardized meaning" of such so-called ESG, green, or sustainable funds. He then said that he had requested that the SEC staff consider recommendations on whether managers of such sustainable funds need to disclose the criteria and underlying data they employ.[103]

Calls from SEC's Investor Advisory and Asset Management Committees

Two SEC advisory committees recommended in 2020 that the SEC consider enhancing reporting requirements for ESG requirements.

First, the Investor-as-Owner Subcommittee recommended that the SEC "begin in earnest an effort to update the reporting requirements of Issuers to include material, decision-useful, ESG factors."[104]

Second, the Environment, Social, and Corporate Governance Subcommittee made a number of draft recommendations, which it called "potential recommendations" for the SEC:

- "mandate the adoption of standards by which issuers disclose material environmental, social, and governance risks";
- "utilize standard setters' frameworks to require disclosure of material environmental, social and governance risks"; and

[100] SEC Commissioner Elad. L. Roisman, "Keynote Speech at the Society for Corporate Governance National Conference," July 7, 2020, at https://www.sec.gov/news/speech/roisman-keynote-society-corporate-governance-national-conference-2020#_ftnref13.

[101] SEC Commissioner Elad. L. Roisman, "Keynote Speech at the Society for Corporate Governance National Conference," July 7, 2020.

[102] SEC, "Request for Comment on Fund Names," 85 *Federal Register* 13221, 13223 (March 6, 2020), at https://www.federalregister.gov/documents/2020/03/06/2020-04573/request-for-comments-on-fund-names.

[103] SEC Chair Gary Gensler, "Prepared Remarks Before the Asset Management Advisory Committee," July 7, 2021, at https://www.sec.gov/news/public-statement/gensler-amac-2021-07-07.

[104] SEC Investor-as-Owner Subcommittee of the Investor Advisory Committee, "Recommendation from the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to ESG Disclosure," May 14, 2020, at https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-of-the-investor-as-owner-subcommittee-on-esg-disclosure.pdf.

- "require that material environmental, social and governance risks be disclosed in a manner consistent with the presentation of other financial disclosures."[105]

The Division of Corporate Finance

The SEC Division of Corporate Finance is charged with ensuring that investors receive disclosures that provide material information that will enable them to make informed investment decisions. Referencing the 2010 climate change guidance, on September 22, 2021, the division provided guidance via sample letters for public companies, which directed them to consider in their climate-related corporate disclosures (or in the absence of such disclosures) the impact of pending or existing climate-change-related legislation, regulations, and international accords; the indirect consequences of regulation or business trends; and the physical impacts of climate change.[106] The Division of Corporate Finance also noted that companies must disclose, in addition to the information expressly required by SEC regulations, "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."[107]

The SEC Division of Examinations

The SEC Division of Examinations (formerly known as the Office of Compliance Inspections and Examinations) has administered the SEC's nationwide examination and inspection programs for various SEC-regulated entities, including investment advisers, national securities exchange participants, private fund advisers, and municipal advisers. In mid-January 2020, the division released a list of 2020 examination priorities for SEC-registered investment advisers. After conducting over 3,000 investment adviser examinations in 2019, the document highlighted several themes for the focus of investment adviser examinations in 2020, including the accuracy and adequacy of disclosures provided by SEC-registered investment advisers who manage emerging vehicles whose investment strategies include ESG criteria.[108]

In April, the SEC's Division of Examinations warned that its review of ESG funds had found a number of misleading statements regarding ESG investing processes and adherence to global ESG frameworks, among other problems.[109] Problems noted included

- Portfolio management practices inconsistent with disclosures about ESG approaches;
- Proxy voting inconsistent with advisers' stated approaches;
- Inadequate controls to ensure ESG-related disclosures and marketing were consistent with actual practices;

[105] SEC Asset Management Advisory Committee, "Potential Recommendations of the ESG Subcommittee," December 1, 2020, at https://www.sec.gov/files/potential-recommendations-of-the-esg-subcommittee-12012020.pdf.

[106] SEC, "Sample Letter to Companies Regarding Climate Change Disclosures," September 22, 2021, at https://www.sec.gov/corpfin/sample-letter-climate-change-disclosures?utm_medium=email&utm_source=govdelivery.

[107] SEC, "Sample Letter to Companies Regarding Climate Change Disclosures," citing Rule 408 under the Securities Act of 1933 and Rule 12b-20 under the Securities Exchange Act of 1934.

[108] SEC Office of Compliance Inspections and Examinations, "2020 Examination Priorities," January 2020, at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

[109] SEC, "The Division of Examinations' Review of ESG Investing," Risk Alert, April 9, 2021, at https://www.sec.gov/files/esg-risk-alert.pdf.

- Unsubstantiated or potentially misleading claims regarding ESG approaches; and
- Compliance programs that did not adequately address relevant ESG issues.[110]

On March 3, 2021, the division announced its 2021 examination priorities, which included an increased focus on climate-related risks. In particular, regarding ESG funds, the Division of Examinations noted that it would "review the consistency and adequacy of the disclosures … provided to clients regarding these strategies, determine whether the firms' processes and practices match their disclosures, review fund advertising for false or misleading statements, and review proxy voting policies and procedures and votes to assess whether they align with the strategies."[111] In response to the exam priorities, Acting Chair Allison Herren Lee observed, "The division is enhancing its focus on climate and ESG-related risks by examining proxy voting policies and practices to ensure voting aligns with investors' best interests and expectations, as well as firms' business continuity plans in light of intensifying physical risks associated with climate change."[112]

Reports had indicated that since 2019, the Division of Examinations had issued a series of examination inquiries, called sweep exams, to investment advisers who manage investment companies with ESG-based portfolios. The inquiries involved a range of questions, including (1) whether the adviser adheres to the United Nation's Principles for Responsible Investment;[113] (2) what ESG investments have been made and were liquidated and the rationales for doing so; (3) the methodology and sources of information used by the adviser to score an investment's ESG credentials; and (4) any proxy votes made by the adviser on ESG issues and the underlying process used to arrive at the decision.[114]

Historically, such industry sweeps have given the SEC staff information on new or evolving practices in an industry. They potentially also give SEC staff enhanced understanding of attendant industry risks.[115]

In conclusion, as noted, pressure both outside of and within the SEC appears to be mounting for the agency to look more closely at its standards for disclosures to investors with regards to climate change risks—both in terms of disclosures by publicly listed companies of material risks, and also for disclosures by ESG funds and in other areas of investment management. The SEC, in turn, has announced a number of new initiatives underway to examine and potentially revise the approach it has used since 2010 in handling climate change risk disclosures under the federal securities laws.

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[110] SEC, "The Division of Examinations' Review of ESG Investing," Risk Alert, pp. 4-5.

[111] SEC, "2021 Examination Priorities," Division of Examinations, p. 28, at https://www.sec.gov/files/2021-exam-priorities.pdf.

[112] SEC, "SEC Division of Examinations Announces 2021 Examination Priorities," press release 2021-39, March 3, 2021, at https://www.sec.gov/news/press-release/2021-39.

[113] Among these principles are (1) incorporating ESG issues into investment analysis and decision-making processes; (2) behaving as active owners who incorporate ESG issues into ownership policies and practices; and (3) seeking appropriate disclosure on ESG issues by the entities in which they invest. See PRI Association, "What Are the Principles for Responsible Investment?" 2020, at https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment.

[114] See, e.g., Anthony Rapa, "Green Sweep? The SEC Turns Its Attention to Environmental, Social and Governance (ESG) and Asset Managers," The Law Firm of Willows, Towers, and Watson, February 19, 2020, at https://www.willistowerswatson.com/en-US/Insights/2020/02/the-sec-turns-its-attention-to-environmental-social-and-governance-esg-and-asset-managers.

[115] Ibid.

Author Information

Rena S. Miller
Specialist in Financial Economics

Nicole Vanatko
Legislative Attorney

Gary Shorter
Specialist in Financial Economics

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