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INSIGHT: Drafting ESG Disclosures—What, Where, and How Matters

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When drafting mandatory or voluntary ESG disclosures, companies must be careful in what they say, how they say it, and where they disclose. Morgan Lewis' Carl A. Valenstein and Celia A. Soehner suggest best practices for both developing ESG programs and making disclosures.

With a new administration and environmental, social, and corporate governance (ESG) a hot topic, we are increasingly receiving inquiries from our public company and private clients concerning best practices in drafting ESG disclosures to avoid potential legal exposure.

There are few ESG-type disclosures mandated under the current regulatory regime, although the pace of such mandates recently has accelerated.

In 2020, the Securities and Exchange Commission adopted disclosure requirements for certain public companies, requiring that they address in their annual reports on Forms 10-K a description of their "human capital resources."

A review of annual reports filed thus far shows that companies are taking divergent approaches. Some are opting to incorporate minimal language that mirrors the prior disclosure requirement to divulge the number of individuals employed. Others—including in the retail and hospitality sectors—are including pages of disclosures that detail their diversity-and-inclusion efforts, compensation and benefits available to rank-and-file employees, and community impact projects and charitable giving.

Other SEC-mandated ESG disclosures and guidance include the conflict minerals disclosure mandated by Dodd-Frank and the 2010 guidance addressing disclosure related to the SEC's disclosure requirements as applied to climate change matters.

Impact of New SEC Leadership

On February 24, acting SEC Chair Allison Herren Lee issued a statement that she is directing the Division of Corporation Finance to "enhance its focus on climate-related disclosure in public company filings" and further indicated that this focused review will help drive changes to the 2010 climate change guidance.

The Biden administration and new leadership at the SEC—including the new role of senior policy advisor for climate and ESG—certainly suggest that the SEC will be increasingly focused on ESG. Upon his appointment as acting head of the SEC's Division of Corporation Finance, John Coates specifically called out "socially productive capital markets" and challenges associated with "rais[ing] and allocat[ing] capital sustainably" in his statement to the media.

Also, with the Democrats in control of Congress, it is possible that more legislation will be introduced to address ESG issues in an attempt to transform stockholder capitalism into stakeholder capitalism. With the filibuster still in effect, though, it is not clear whether the Republican minority will be able to block these initiatives. Certain Republicans have already taken aim at the recent Nasdaq-proposed rules to address diversity.

Areas of Focus: Climate Change, Covid-19, Diversity

Companies we have spoken with certainly hope that the direction of these initiatives is more in line with the less prescriptive human capital disclosure rules than the more prescriptive and burdensome conflict mineral rules, but that remains to be seen.

Key ESG areas of focus for regulatory or legislative initiatives are likely to be climate change (as evidenced by acting Chair Lee's recent pronouncements), Covid-19 and other health-and-wellness issues, and diversity-and-inclusion efforts.

Even without mandated disclosures, a growing number of companies have made voluntary ESG disclosures in their standalone sustainability reports and in proxy statements due, in part, to pressure from various stakeholders—activist stockholders, stockholder advisory groups, consumer watchdog groups, and the companies' own employees.

In the continued world of private ordering of ESG disclosure, and with the advent of increased regulation, companies will need to tread carefully with the specter of increased litigation relating to these disclosures, though it remains to be seen if these cases will survive motions to dismiss.

Best Practices for Developing an ESG Program

Care must be exercised by companies in what they say, how they say it, and where they disclose ESG topics, because all of these can have legal consequences. An important first step is developing an ESG program that follows certain established best practices:

- Define ESG goals, key performance indicators (KPI), and rating systems/metrics, looking at peers/competitors.
- Engage with C-suite/board on ESG goals. Prioritize the time and resources needed to support ESG goals.
- Engage with other internal stakeholders—not just the legal department—along with third parties, advisers, shareholders, and other stakeholders, on achieving ESG goals.
- Communicate the strategic importance of ESG goals with the disclosure team.
- Develop disclosure and reporting policies and procedures.
- Consider forming an ESG reporting and disclosure committee or giving this duty to one of the board's standing committees.

Best Practices for ESG Disclosures

In addition to following best practices for developing an ESG program, a company should consider the following in connection with any ESG disclosures made in an SEC filing:

- Before drafting, focus on the company's particular risk profile and opportunities against the backdrop of long-term operational and financial performance goals. What you say will depend heavily on your industry, business, and particular facts and circumstances, including the company's approach to risk management.

- Connect the dots between the ESG topics on which you are reporting and the company's long-term value creation strategy.

- Use plain English. The current ESG disclosure framework is fractured, with no standardized disclosure. Ensure that your language makes sense and can be easily compared to what your peers are saying.

- Avoid language that could be interpreted as a firm commitment, as opposed to an aspirational goal, and include appropriate disclaiming language.

- Involve legal counsel to help review any ESG disclosures to make sure they are properly validated and qualified because of potential liability.

- Highlight the appropriate ESG metrics/KPIs for your industry, any participation in industry initiatives, and any third-party validation of your ESG metrics/KPIs.

- Because of the greater legal liability with respect to disclosures included in documents filed with the SEC (10-Ks and proxies), care should be given to the location of the disclosure,

recognizing that there is still potential liability for fraud with respect to intentional misstatements made in sustainability reports not filed with the SEC, but rather posted on the company's website.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

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