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SEC Comment Letters on Environmental Matters

Thoughts on climate change disclosures and responding to SEC staff comments

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While the environmental, social and governance (ESG) arena may soon see a seismic shift in disclosure requirements, there has been no shortage of regulatory scrutiny based on existing requirements. No matter one's viewpoint on ESG, the reality is companies need to take notice. The U.S. Securities and Exchange Commission's (SEC or Commission) Division of Corporation Finance (Corp-Fin) has been busy on the ESG disclosure front through comments to SEC registrants (i.e., public companies). Understanding the SEC comment letter process and current trends is important in keeping within the good graces of this important regulator. This article focuses on the 'E' of ESG by drawing attention to recent environmental and climate-related comments through a report conducted by MyLogIQ entitled *An Analysis of Climate Related Comment Letter Themes* (Report)[1]. This Report is based on research from MyLogIQ's comment letter database and analyses 620 environmental and climate-related comments issued by Corp-Fin to 76 public companies between July 2021 and January 2023. The Report identifies eleven broad themes relating to the following three key conclusions:

1. *Companies should be prepared to discuss the physical effects of climate change on their operations and cost of insurance.*
2. *Companies should synchronize the content of their publicly posted reports with that of their 10-K and 20-F annual reports.*
3. *Management discussion and analysis (MD&A) and risk factor items of SEC filings had the most comments.*

This article offers commentary on the Report findings, as well as some ideas for public companies in preparing for and responding to Corp-Fin comment letters.

But first, a little history

Regulatory attention from the SEC regarding public company ESG disclosures has been a hot topic ever since the Sarbanes-Oxley Act of 2002. Recent attention has been especially on the 'E' fueled by a Sample Letter released by Corp-Fin in September 2021. This Sample Letter references *Commission Guidance Regarding Disclosure Related to Climate Change* (Release No. 33-9106), which was released back in 2010, so this topic is far from new. In addition, the SEC received approximately 14,000 comment letters to their March 2022 proposed rule, *The*

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[1] Used by permission of MyLogIQ for purposes of this article. MyLogIQ has an Artificial Intelligence (AI) powered SaaS platform that also leverages Machine Learning to provide public company intelligence.

Enhancement and Standardization of Climate-Related Disclosures for Investors (Release No. 33-11042), and we are awaiting a potential final rule or perhaps a redraft of the proposed rule.

Returning to Corp-Fin's recent types of environmental and climate-related comments as captured through the Report, here are some thoughts regarding the three conclusions and relating themes.

Be prepared to discuss the physical effects of climate change on operations and related costs

By far, this conclusion relates to the most common themes seen in climate-related comment letters (refer to the Report for specific comment letter examples to each of these themes):

- Physical effects of climate change on operations and cost of insurance
- Material effects on transition risks related to climate change
- Material litigation risks related to climate change
- Identify past or future material capex on climate related initiatives for each period
- Indirect consequences on business trends
- If there is evaluation on indirect consequences on business, how did you evaluate the factors
- Cost of insurance due to weather conditions
- Compliance costs related to climate change
- Nature of business, climate change regulations and legislation, including difficulty in assessing timing and effect of pending legislation
- Disclosure on purchase/trading of carbon credits

Simply stated, the SEC wants public companies to identify and disclose all material effects of environmental and climate-related developments, especially relating to the business, financial condition, and results of operations. This includes the direct physical effects of climate change on operations and financial results, such as droughts, floods, windstorms, hurricanes, extreme fires, water availability, water quality, as well as any weather-related impacts on the cost or availability of insurance. As some insurers are moving away from underwriting certain carbon-intensive businesses, insurance premiums are likely to become more costly and a material disclosure.

An important consideration is a focus not just on the past, but more importantly what future risks are lurking (i.e., 'transition risks'), such as regulatory changes, market trends, credit risks, technology changes, etc., that could reasonably usher in additional operational and compliance costs. Also, 'indirect consequences' of client-related regulation or business trends, such as changing demand for goods or services that produce significant greenhouse gas emissions or those related to carbon-based energy sources, are being questioned in terms of materiality for disclosure purposes. Controls over the judgments of materiality conclusions should be in place.

Other types of costs SEC staff is questioning pertain to compliance and regulatory activities, and the costs (or income) associated with carbon credits. Corp-Fin is looking for quantitative information on these transactions if deemed material.

Synchronize the content of publicly posted reports with periodic reports filed with the SEC

Keep in mind that it is not only SEC filings that Corp-Fin is looking at, but theoretically any company information in the public domain, including websites, press releases, marketing materials, investor reports, and corporate social responsibility (CSR) reports. The Corp-Fin review team will likely ask for an explanation if they see significant differences. Therefore, it is prudent to align environmental disclosure between CSR reports and SEC periodic reports, current reports, and proxy statements. For example, some comments are now asking about the role of the board of directors regarding its oversight function relative to climate change and any related risks this has on company leadership structure, especially if discussed in a CSR report but not in the proxy statement.

Focus on ESG considerations in the MD&A and risk factors to avert potential SEC comments

Many of the themes relating to addressing the physical effects of climate change on operations and costs as previously covered are also applicable to this conclusion. While 'materiality' for disclosure purposes is highly judgmental and contingent of both quantitative and qualitative considerations, ESG matters are seemingly becoming increasingly important to certain stakeholders, such as investors, customers, employees, suppliers, governments, and creditors. As a result, these shifting attitudes should factor into the materiality consideration, especially in MD&A disclosures and risk factors, since these stakeholders are often interested readers of SEC filings. Therefore, Corp-Fin has asked for revised disclosures to more clearly address the consequences of 'reputational risks' resulting from operations that produce greenhouse gas emissions.

Be prepared

Preparing for and responding to SEC comment letters is a critical activity for public companies looking to stay within the good graces of the Commission. One certainty for SEC registrants is that they will be reviewed by Corp-Fin at least once every three years thanks to Section 408 of the Sarbanes-Oxley Act, but this most certainly can happen more often. When it does happen, will the company panic and simply call their auditors and SEC counsel, or is this already baked into a plan to be efficiently and effectively executed?

Of course, a well thought out plan to execute can help to reduce stress and save resources. Here are some ingredients to consider in developing an SEC comment letter response plan:

1. Identify the team, including internal and external resources. Legal counsel, together with the CFO's office, generally takes overall responsibility. And for accounting matters, it will be important to involve your principal accounting officer and independent auditors.

2. Responding to an SEC comment letter, unless it is a simple inquiry or two, should be viewed as a 'project' thus necessitating a 'project manager.' While many people are generally involved, there should only be one project manager for coordination and version control purposes.

3. The project should be treated as a high priority, as the expected turnaround time to address Corp-Fin's comments is typically only 10 business days. The company should let the Corp-Fin reviewer know as early as possible if they can't meet the requested timeline, along with the reasons. Remember that late filings and comment letter responses can be viewed as a red-flag by SEC staff.

4. Once everyone has had a chance to review the comment letter and to discuss potential responses, the organization should consider confirming its understanding of comments with the SEC reviewer. This is especially important for difficult comments subject to judgmental interpretations. I have seen too many response teams go down rabbit-holes that were unnecessary simply because they did not fully understand Corp-Fin's comments

and what they were looking for thus wasting significant resources. This should be done early in the process (ideally by business day two or three at the latest) under the guidance of SEC counsel and the CFO's office.

5. Consider obtaining recent examples of comments, responses and Corp-Fin conclusions similar to the company's comments and ideally within the same industry group. While it is not advisable to copy responses from other SEC registrants since no two companies are identical, it is wise to consider other responses in terms of what was and was not acceptable to the Corp-Fin review teams. Leveraging an artificial intelligence platform to contextually search for relevant comment letter strings can provide valuable insights. Artificial Intelligence (AI) tools offer the advantage over legacy tools of cutting hours of research and costs while providing precedence and facts for benchmarking.

6. Apply disclosure controls and procedures to help ensure that responses are accurate, complete, timely and supported. It is not uncommon for Corp-Fin to ask for support to your numbers, disclosures and conclusions.

7. Learn from the comment letter response efforts and debrief with the team. What worked and didn't work, and what can be done to avoid future comments?

Keep in mind that if a company that is a SEC registrant does not hear from Corp-Fin staff every three years that simply means their review team had no matters of clarification or concern to communicate, and hence no SEC comment letter. Isn't this a nice goal for public companies?

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