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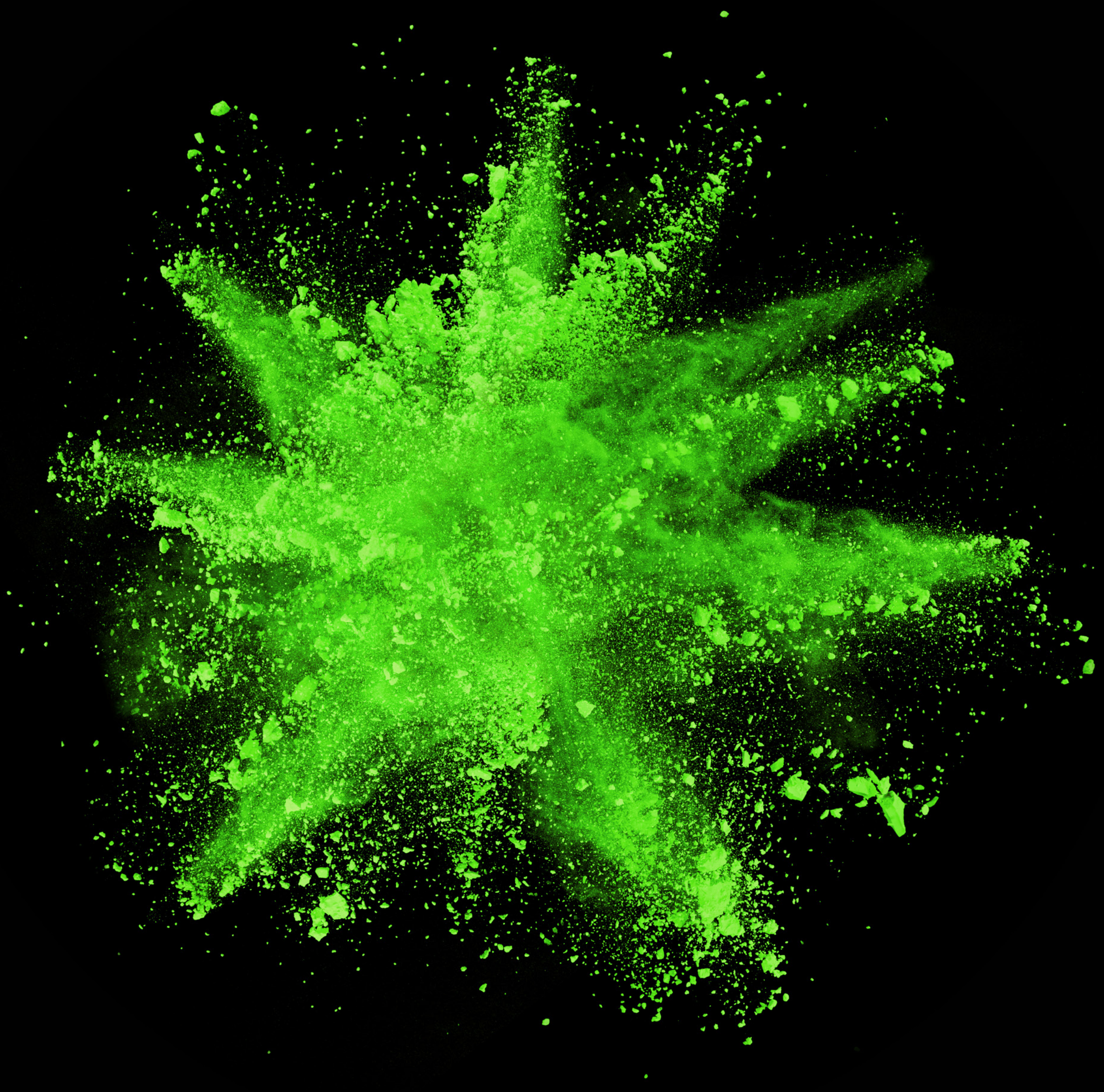


New Environmental, Social, and Governance (ESG) disclosure regulations are on the horizon. Are you ready?

There's a new sheriff in town—and public companies that issue corporate responsibility statements are officially on notice.

In a March 4, 2021 press release[1] the US Securities and Exchange Commission (SEC) announced it had formed a task force on environmental, social, and governance issues. The mission? To identify public companies and investment funds that mislead the public about their climate risks or environmental, social, and governance (ESG) strategies. Some of that disclosure may come from tips and referrals through the SEC's whistleblower hotline. Other investigations may stem from sophisticated data analytics capabilities that are at the SEC's disposal.

Catching up to the market

The specific SEC task force may be new, but SEC scrutiny is not. In 2019, the SEC sent letters to managers of ESG investment funds in an effort to examine how they determined companies' ESG performance.[1] By then, interest in ESG assets was surging, with total investments approaching $15 trillion.[2]

With so much at stake, investors stand to benefit from a clear set of rules for what counts as sustainable. Whether that means updated guidance from the SEC or the establishment of a standard-setting organization in the mold of the Financial Accounting Standards Board, effective disclosure guidelines could bring greater transparency, objectivity, and comparability to ESG reporting. Standards could also help companies and investment managers by leaving less room for misunderstandings over what the organization says about its ESG efforts.

1. https://www.sec.gov/news/press-release/2021-42
2. https://www.sec.gov/news/speech/lee-climate-change

Truth or consequences

That last point is important because a 'disclosure misfire' might have significant repercussions even outside the context of a broader regulatory crackdown. Consider the hypothetical case of a company that highlights the sustainability of its operations in its annual report, then discloses contradictory ESG strategies in its financial statements. If it becomes known that the company strategies do not align with its supposed sustainable operations and shareholders had relied on the claims of sustainability as a basis for making their investment in the company, such shareholders may feel that they were misinformed. If the SEC picks up on it, the result could be a subpoena and an investigation.

So why make ESG disclosures in the first place? The simple answer is that stakeholders are calling for them.[2] ESG extends beyond climate change to include corporate diversity, worker health and safety, and a host of other concerns that are cropping up in the business environment. That's led to ESG performance becoming a key differentiator in attracting customers, employees, financial backers, and welcoming communities. Realizing this, investors are demanding more details about how companies are tackling ESG issues so they can make more informed decisions about where to allocate their capital.

When risk culture goes sideways

But pressures like these can also give rise to internal misconduct. Examples that come to mind include:

- **Financing.** Companies could gain greater access to capital by providing inaccurate or incomplete information. For instance, they could adjust data or incorrectly categorize projects as green to meet specific targets.
- **Remuneration.** Companies may tie executive compensation to ESG performance. That could tempt some executives and others within the organization to provide falsified information to the compensation committee or board of directors.
- **Internal Controls.** Insufficient or unclear segregation of duties and responsibilities, lack of clear governance structures, and weak documentation processes can boost the chances of incorrect or fraudulent ESG reporting.

What the SEC decides to do about regulatory reporting has a direct bearing on another risk. If the requirements become stringent, companies may fudge the data in an attempt to get by.

The building blocks of managing ESG disclosure risk

The upshot is that proactive risk management is more important than ever, regardless of how current regulatory activity plays out.

A foundational step in enhancing the risk management program is to create a process for assessing the accuracy of an organization's ESG claims that are disclosed to the public. Are ESG metrics calculated correctly? Are the comments that representatives make to the media—including social media—consistent with one another and with what the company is reporting to regulators?

After that, consider developing a framework to support behaviors that manage ESG risks. A code of conduct is part of that, along with compliance policies and procedures around ESG reporting and disclosures. An effective risk culture also requires training and communications that clearly articulate senior management's views about ethics and integrity as they relate to ESG.

[1] https://www.sec.gov/news/press-release/2021-42
[2] https://www.sec.gov/news/speech/lee-climate-change

A compliance function specific to ESG can also help to establish and maintain standards of conduct. Lay the groundwork with a review of current ESG disclosure practices and procedures. Next, create a governance model with clearly defined roles and responsibilities, a compatible organizational structure, and oversight committees. Follow up with appropriate incentives and disciplinary measures, along with a confidential reporting hotline.

Don't forget to periodically test the internal controls and hotline. Finally, schedule a periodic formal fraud risk assessment around the ESG reporting mechanism.

Getting ahead of ESG risks

Despite management's best efforts, a company still could encounter a disclosure misfire or an instance of employee misconduct. When that happens, an investigations capability can help to determine what went wrong and where other exposures might exist. (It's worth noting that an exposure isn't always about what's been said—sometimes risk arises from what isn't being disclosed but perhaps should be.)

Consider also including a plan to enhance existing protocols—one that can be shared with investors, regulators, and the general public as evidence of what the company is doing to reduce the risk of future missteps. That might include a process to identify two categories of risk: the threats that ESG issues pose to the company and the impact of company operations and assets on ESG.

Internally, a measurement and monitoring capability can help companies understand the ESG disclosure risk in their organization. Paired with a strategic plan to manage and mitigate the climate-related risks that monitoring uncovers, the company can develop the framework to attempt to stay on top of disclosure risk in a consistent manner.

Get ready for a new disclosure environment

Momentum has been building for greater accountability around corporate responsibility. Now the SEC has made it clear: Company claims about ESG will be held up to scrutiny. With new rule-making and enforcement on the horizon, many signs point to ESG disclosure risk becoming a board-level priority.

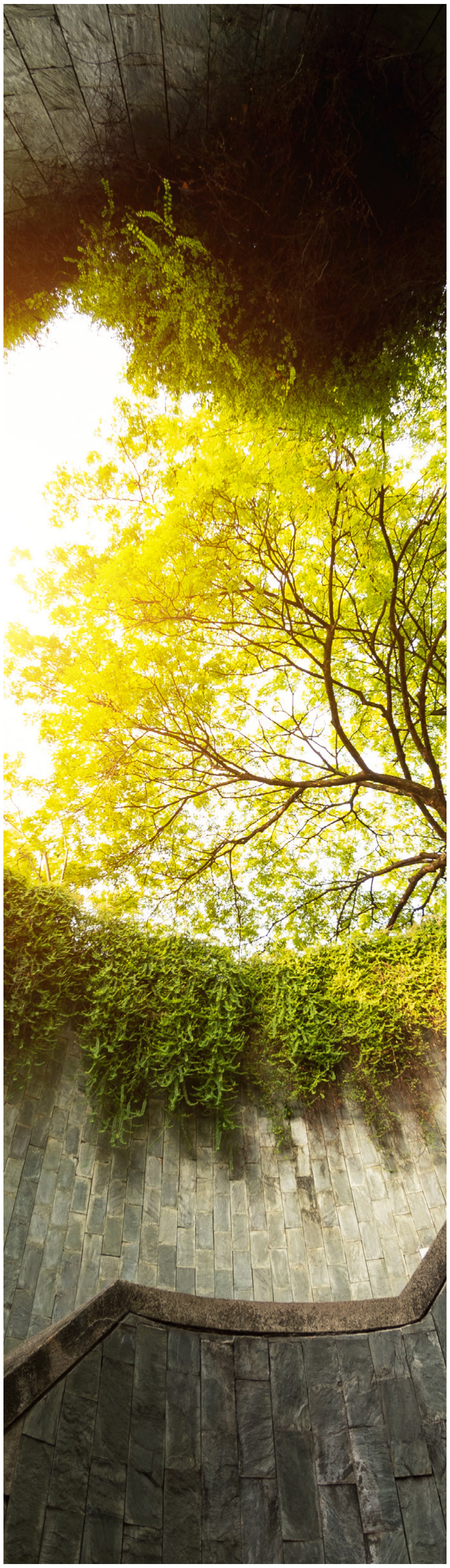
Even so, it doesn't have to be all about compliance. An effective response can help companies manage disclosure risk even as they earn stakeholder trust by providing more useful information about their ESG position. By disclosing a comprehensive program that includes these elements, public companies can persuasively convey that they're proactively addressing ESG risks while building more resilient business operations.

How Deloitte can help

The Deloitte ESG Forensic team combines cross-sector industry and commercial acumen to help clients drive value through their ESG strategies, while carefully addressing and assisting them to mitigate their risk.

We can help with every stage of the ESG reporting process. That includes ESG risk assessments followed by development of ESG-related metrics, strategies, and programs. We also assist with discussions over ESG disclosures.

Should your company become the target of a legal or regulatory enforcement action, we can help you initiate an internal investigation—including e-discovery and personnel interviews—to get to the bottom of the issue. We can quickly mobilize specialists across geographies to assist with cross-border investigations. Our extensive experience engaging with the SEC can help you resolve inquiries in a discreet, expedited fashion.



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Endnotes

1. Juliet Chung and Dave Michaels, "ESG Funds Draw SEC Scrutiny," Wall Street Journal, December 16, 2019, https://www.wsj.com/articles/esg-funds-draw-sec-scrutiny-11576492201?mod=article_inline.
2. Andrew Ramonas, Amanda Iacone, and Nicola M. White, "SEC's Next Difficult Task for ESG Is Finding a Standard Setter," Bloomberg Tax, April 13, 2021, https://news.bloombergtax.com/financial-accounting/bidens-sec-faces-uphill-battle-to-form-esg-reporting-body.

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