

INSIGHTS

Prepare For More Financial Scrutiny Ahead

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CFOs already grappling with the impact of the coronavirus pandemic and uncertainty about its impact on labor, real estate and other long-term costs will have several new challenges to consider in the coming year. SEC enforcement and securities litigation are already on the upswing. Many companies are being asked by regulators, investors and other key stakeholders to detail and quantify the impact of the pandemic and sustainability practices and more generally demonstrate performance within critical environmental, social and governance factors (ESG).

These changes are expected to accelerate as the Biden Administration unfolds. Consequently, CFOs must anticipate greater scrutiny regarding their reporting of risks across a far broader array of factors and issues than in the past. Working closely with their legal counsel and investor relations teams, they will need to prepare strategies to preempt enforcement action or securities litigation that could follow perceived deficient disclosure.

A New Standard for SEC Enforcement

The SEC has clearly sent a message regarding the importance it will place on accurate disclosures concerning the pandemic. One such example has been the announcement of settled charges against The Cheesecake Factory in December 2020, when it warned it “will continue to scrutinize Covid-related disclosures to ensure that investors receive accurate, timely information.”

It is widely believed that there will be more aggressive enforcement under the Biden Administration, and recent developments confirm that the SEC will be more focused on enforcing matters pertaining to climate risk and ESG:

- On February 1, 2021, the SEC announced the appointment of its first-ever senior policy advisor for ESG issues, to coordinate the SEC’s “regulatory framework across [its] offices and divisions.”
- On February 24, 2021, the Acting Chair of the SEC, Allison Herren Lee, directed the Division of Corporation Finance to “enhance its focus on climate-related disclosure in public company filings” and to review and update the 2010 guidance on climate disclosures to reflect “developments in the last decade.”

- On March 3, 2021, the SEC's Division of Examinations announced its 2021 priorities that highlighted "enhancing its focus on climate and ESG-related risks."
- On March 4, 2021, the SEC announced the creation of a Climate and ESG Task Force "to proactively identify ESG-related misconduct," and "identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules."

The SEC views climate change not only as an investment risk, but also as a systemic risk to financial markets and as such, it intends to make ESG a priority, with an emphasis on "uniform, consistent, and reliable disclosure," [according to Acting Chair Lee](#). This is an item that CFOs will need to pay particular attention to as they consider where to deploy company capital.

Further, Lee recognized that ESG risks are critical factors in investment strategies: "[t]he bottom line is that businesses now actively compete for capital based on ESG performance, and that competition needs to be open, fair and transparent." Lee has also made the point that issuers and financial institutions should "produce standardized, comparable and reliable disclosure of their exposure to climate risk," including indirect risk related to the financing they provide. The SEC is keeping a close eye on funds and their investment advisers for ESG disclosures as well.

It is clear that the SEC will be closely scrutinizing all disclosures to ensure issuers accurately and reliably disclose ESG-related material risks.

Preparing for ESG-Related Securities Litigation

Even with a decline in M&A activity and pandemic-related court closures, the overall number of new securities litigation filings was still near record highs with over 334 class actions filed in 2020, according to Cornerstone Research data. It is anticipated that substantial class action activity will continue in 2021 and beyond; it is easier than ever for would-be plaintiffs to connect with plaintiffs' counsel through the internet and social media.

As Covid, climate risk and ESG issues remain a focus area of the SEC, institutions and the investing public, companies can expect securities litigation based on these disclosures to increase. This litigation surge will likely be driven by both actions filed following SEC enforcement as well as independent shareholder actions. We have already seen this play out over the last few years as the #MeToo movement, environmental events and cybersecurity breaches have led to securities class actions that negatively affect stock price and company value. Failure to adequately disclose, or misleading disclosures of what transpired along with associated risks, will continue to fuel many securities actions.

To prepare for the coming wave of enforcement and litigation, CFOs should review their policies and procedures to ensure proper Covid-19, climate risk and ESG-related disclosures. It is crucial for protecting corporate value in an era of significant social change and market interest that the expectations of shareholders and regulators be anticipated. CFOs and their teams also need to be prepared to respond to unexpected events, and to be able to do so in real time with sufficient disclosures and appropriate communications to help mitigate enforcement and litigation risk.