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CLIENT MEMORANDUM

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SEC Poised to Consider ESG Disclosures

This client alert, part of a series focused on ESG disclosure and regulatory developments, should be read together with our ESG Lexicon, available here, which provides definitions of some of the key terms used in ESG reports, disclosures and regulations.

The SEC closed its period of public comment on the topic of climate-change disclosures over the weekend after receiving hundreds of submissions. The comments, not surprisingly, reflected a range of views regarding climate-related disclosures, including whether the SEC should or must limit itself to requiring only financially material. These comments are the latest in an ongoing discussion among SEC Commissioners and staff, lawmakers, public companies and investors about the propriety, drawbacks and potential scope of SEC rulemaking mandating climate-related information. And they come about as SEC Chair Gary Gensler begins implementing his rulemaking agenda, with the new chairman changing the leadership of the Public Company Accounting Oversight Board on June 4 and releasing his first agenda of regulatory priorities on June 11.

In this Client Alert, we review several recent statements and actions by the SEC and the broader federal government in the area of climate-change disclosures;[1] we discuss the reaction of key industry participants and observers to the prospect of climate-change disclosures during a public comment period; we provide an overview of the scope of the SEC's authority to promulgate climate- and ESG-related disclosure rules; and we discuss several topics the SEC would be required to cover in any administrative record.

Past Actions Related to Climate-Change Disclosures

The SEC released its most recent guidance on climate change in 2010, during the Obama Administration, which we covered in more depth in a July 2020 client alert.[2] In a review of then-current rules, the guidance identified a number of items in Regulation S-K that could require climate- or ESG-related disclosures, including Item 101 (implicating, among other things, disclosure of environmental law compliance costs), Item 103 (pending environmental legal proceedings), Item 503(c) (risk factors) and Item 303 (Management's Discussion and Analysis of Financial Condition and Results of Operations). The 2010 guidance indicated that climate change could implicate these items through the following sources: (1) the direct impact of climate-change legislation and regulation; (2) the impact of international climate-change accords; (3) the indirect impact of climate-change regulation and business trends, *e.g.*, decreased demand for goods that produce greenhouse gas emissions; and (4) the physical impacts of climate change.

Soon after the inauguration of President Biden, executive officials took several actions with respect to climate- and ESG-related disclosures. On March 4, the SEC announced the creation of a Climate and ESG Task Force in its Division of Enforcement; we discussed this task force and the broader regulatory environment in a March 2021 Client Alert. On May 20, President Biden issued an Executive Order on Climate-Related Financial Risk that called on the federal government to take concrete steps to mitigate the physical and transitional risks of climate change. Among other steps, the Executive Order directed the Secretary of the Treasury to work with the Financial Stability Oversight Council to review climate-related disclosures. Additionally Rostin Behnam, the Acting Chairman of the Commodity Futures Trading Commission, established a Climate Risk Unit on March 17 to "focus[] on the role of derivatives in understanding, pricing, and addressing climate-related risk and transitioning to a low-carbon economy."

Public Input on SEC Climate-Change Disclosures

On March 15, then-Acting-Chair Commissioner Lee called for public input on disclosures related to climate change. As we indicated in a client alert issued shortly afterwards, Commissioner Lee cited "demand for climate change information and questions about whether current disclosures adequately inform investors" in requesting input from "investors, registrants, and other market participants." Commissioner Lee articulated 15 questions 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 is the best approach for requiring climate-related disclosures? For example, should any such disclosures be incorporated into existing rules . . . or should a new regulation devoted entirely to climate risks, opportunities, and impacts be promulgated?"
- "What are the advantages and disadvantages of developing a single set of global standards applicable to companies around the world . . . ?"

In addition to comments addressing the contents and form of climate-change disclosures, a group of submissions addressed whether the SEC should or must limit itself to financially material disclosures. Several academic observers from Vanderbilt Law School and the Carey Law School at the University of Pennsylvania provided historical perspectives on the concept of materiality within the context of financial disclosures. The Attorney General of West Virginia submitted a comment in opposition to any prospective rule, raising First Amendment concerns. And a group of Republican members of Congress opposed action on ESG disclosures, arguing that such rules would "take [the SEC] far afield of its statutory mission to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation," while Democratic Senators Schatz and Whitehouse supported both climate and political spending disclosures. Businesses differed on whether they viewed climate-related disclosures to be material: for example, Ernst & Young broadly supported the materiality of climate-related disclosures, while U-Haul argued that a prescriptive ESG disclosure standard focused on social policy would be arbitrary and capricious, as well as hard to justify under the required cost-benefit analysis. And Uber Technologies, while stating that it supports a climate-disclosure framework that incorporates TCFD or SASB standards and is generally principles-based, encouraged the SEC to require reporting entities to perform "a company-specific materiality assessment to identify the ESG issues most relevant to their businesses," rather than "generic ESG disclosures."

Business groups have reacted to these regulatory topics outside of the SEC's comment process, as well. On May 11, the Chamber of Commerce encouraged Chairman Gensler to focus on "investor-driven material disclosures," describing "the court-established definition of materiality" as the "bedrock of our capital markets." In contrast, before the SEC requested public input, BlackRock advocated for improved climate- and ESG-related disclosures stating that "[t]here is no company whose business model won't be profoundly affected by the transition to a net zero economy" and that "investors cannot prepare their portfolios for this transition unless they understand how each and every company is prepared both for the physical threats of climate change and the global economy's transition to net zero." Nearly all commentators, however, have focused on political or policy objections, rather than articulating any affirmative legal objection to rules concerning climate- and ESG-related disclosures.

The comment period closed on June 13, with members of the public and industry stakeholders having submitted over 320 individual comments, and SEC staff has indicated rulemaking could occur soon. On April 30, John Coates, then the Acting Director of the Division of Corporation Finance, urged those interested in commenting to submit their comments "sooner rather than later," saying "[w]e're not going to be moving slowly. . . . We're going to be moving relatively promptly on this front . . . ."

Approximately two weeks later, on May 19, Chairman Gensler confirmed that he would seek the promulgation of rules requiring the disclosure of climate change-related information, calling the effort one of his "top priorities" and an "early focus." He further expressed his belief that "investor demand should guide our thinking in this work." And in a news release discussing SEC regulatory priorities released on June 11, Chairman Gensler highlighted climate-change disclosures as his first "notable" rulemaking effort.

SEC Rulemaking Authority

SEC Commissioner Allison Herren Lee recently discussed "myths and misconceptions about 'materiality'" in a May 24 speech about climate-change disclosures. Speaking to an audience of auditors, attorneys and other disclosure professionals, Commissioner Lee in particular addressed the legal authorities empowering the SEC to promulgate those rules. Commissioner Lee explained her view that limiting SEC rulemaking to requiring disclosures that are material "is legally incorrect, historically unsupported, and inconsistent with the needs of modern investors, especially when it comes to climate and ESG." First, she noted that relevant provisions of the Securities Act and Exchange Act authorizing rulemaking in this context are not "qualified by 'materiality.'" Rather, she explained, the concept of materiality arises in the context of the anti-fraud provisions of Rule 10b-5 promulgated under Section 10(b) of the Exchange Act and Rule 14a-9 promulgated under Section 14(a) of the Exchange Act. Materiality, she noted, places limits on liability and should not be viewed as a legal limitation on SEC disclosure rulemaking. Second, she observed that Regulation S-K, governing disclosures required by the Securities Act and the Exchange Act, often requires "information that is important to investors but may or may not be material in every respect to every company making the disclosure." She cited as examples items of Regulation S-K requiring the disclosure of related-party transactions, environmental proceedings, share repurchases and executive compensation—none of which has a materiality threshold.[3]

The statutory authority for regulation to which Commissioner Lee referred typically comes from a combination of Sections 7, 10 and 19 of the Securities Act and Sections 3, 12, 13, 15 and 23 of the Exchange Act.[4] Of relevance to disclosure requirements in registration statements, prospectuses and periodic reports:

- **Sections 7 and 10 of the Securities Act** both authorize the SEC to require disclosures in registration statements and prospectuses that are "necessary or appropriate in the public interest or for the protection of investors."[5]

- **Section 13 of the Exchange Act** authorizes the SEC to require disclosures in periodic reporting by public companies as is "necessary or appropriate for the proper protection of investors and to insure fair dealing in the security."[6]

In addition to these standard authorities, Congress passes legislation from time to time instructing the SEC to require specific disclosures. For example, in 2010, the Dodd-Frank Act amended Section 13 of the Exchange Act to require disclosures relating to "conflict minerals."[7] Although there is no current legislation specifically mandating disclosures related to climate change, members of the 117th Congress have introduced three bills that would establish such a requirement:

- **The Corporate Governance Improvement and Investor Protection Act**, H.R. 1187, would require an issuer of securities to annually disclose to shareholders certain ESG metrics and their connection to the long-term business strategy of the issuer.

- **The CLEAN Future Act**, H.R. 1512, would require the SEC to promulgate rules requiring issuers to disclose information relating to, among other things, direct and indirect greenhouse gas emissions of the issuer and its affiliates, fossil fuel-related assets owned or managed by the issuer and climate-related risk disclosures by industry or sector.

- **The Climate Risk Disclosure Act of 2021**, H.R. 2570 & S. 1217, would require the SEC to promulgate rules requiring issuers to annually disclose certain climate-related information to the public, including physical and financial risks they would face under different climate-change scenarios, strategies and corporate governance processes in place to manage those risks, and their analysis of the social cost associated with the issuer's greenhouse gas emissions.

The House of Representatives passed H.R. 1187 on June 16 by a vote of 215 to 214. H.R. 2570 has been reported out of committee, with the Chamber of Commerce opposing it after a markup session. In a May 12 letter, the Chamber indicated its support for an "approach to ESG reporting [that is] rooted in the Supreme Court's well-established concept of materiality." The other bills remains in committee.

Limitations on SEC Rulemaking Authority

The SEC's rulemaking authority is limited by the Administrative Procedure Act, which authorizes a court to invalidate agency action that is, among other things, "in excess of statutory jurisdiction" or "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[8] Informal notice-and-comment rulemaking, in particular, is limited in roughly two ways: (1) by the terms of the statute granting the agency such authority and (2) by the need for agency action to be supported by the administrative record.[9]

Unless a new law is passed, the SEC must depend on existing authority, including that granted by Sections 7 and 10 of the Securities Act and Section 13 of the Exchange Act, to require climate- and ESG-related disclosures in registration statements, prospectuses and periodic reporting. Accordingly, if the Commission promulgates a rule without offering a reasonable interpretation of "necessary or appropriate in the public interest or for the protection of investors,"[10] in the case of registration statements and prospectuses, "necessary or appropriate for the proper protection of investors and to insure fair dealing in the security,"[11] in the case of periodic reporting, or other relevant statutory provisions, then the SEC is limited in its rulemaking authority. The scope of these statutory authorities would likely be interpreted in the context of the Acts' purposes of, among other things, "insur[ing] the maintenance of fair and honest markets in [securities] transactions."[12]

The SEC's authority is also limited by the contents of the administrative record it compiles in support of any rule requiring climate- or ESG-related disclosures.[13] The Supreme Court has explained:

> [A]n agency rule would be arbitrary and capricious if the agency has [1] relied on factors which Congress has not intended it to consider, [2] entirely failed to consider an important aspect of the problem, [3] offered an explanation for its decision that runs counter to the evidence before the agency, or [4] is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[14]

Rulemaking by the SEC in this context may be further limited in at least the following two ways:

First, the SEC, per Section 23 of the Exchange Act, will be required to analyze the costs and benefits of any rule and ensure that it does not "'impose a burden on competition not necessary or appropriate' to advance the purposes of securities laws."[15] Its analysis must be well-reasoned and supported by the record; otherwise a court may remand the rule to the agency for further explanation.[16] Other provisions, including Section 2 of the Securities Act and Section 3 of the Exchange Act, may require the SEC to analyze additional considerations, including whether any rule "will promote efficiency, competition, and capital formation."

SEC Commissioner Elad Roisman discussed the topic of costs and benefits in June 3 remarks at a Corporate Board Member event. Commissioner Roisman said that the SEC will "need to be reasonable in our expectations of what companies can disclose and how they disclose it," noting in particular that environmental information is "difficult to calculate, and sources for it are not always reliable." He also recognized that with "any new disclosure requirement," companies will face costs in obtaining and presenting the new information and "increased liability for making such disclosures." To combat these costs, Commissioner Roisman proposed limiting the companies affected by any disclosure rule and a safe harbor to reduce litigation costs.

Second, the SEC may need to provide an explanation for any departure from previous approaches to regulation when promulgating a rule for climate- or ESG-related disclosures. "[W]hen an agency determines to change an existing regulatory regime it must do so on the basis of 'reasoned analysis.'"[17] Accordingly, to the extent any rule presents a departure from previous approaches or topics of SEC rulemaking, the SEC must recognize that departure and describe the reasoning behind it in the administrative record. Indeed, at least one academic observer has noted climate-related disclosures could be such a departure, suggesting that "adopt[ing] a framework for companies to use to disclose information on a broad set of topics, without establishing that any one of those topics is in fact financially material, is an unusual foray into SEC rulemaking."[18]

Conclusion

As the SEC sharpens its focus on climate- and ESG-related disclosures, and in the wake of the end of the public comment period, the prospect of additional rulemaking continues to increase. The content of, rationale for and authority for any proposed rule will likely be closely scrutinized if and when the SEC issues a Notice of Proposed Rulemaking. As part of our continuing coverage of this and other ESG-related issues, we will publish further alerts regarding future developments.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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1 For further analysis of SEC actions in this area, see our prior client alerts: Acting SEC Chair Lee Discusses Additional Climate and ESG Initiatives, SEC Turns Up The Heat on Climate and ESG Disclosures, and Acting SEC Chair Allison Herren Lee Issues Statement on the Review of Climate-related Disclosure.

2 75 Fed. Reg. 6290 (Feb. 8, 2010). We reviewed the 2010 guidance in more depth in a July 2020 Client Alert.

3 At least one academic commentator has observed that the SEC typically uses the concept of materiality as a guide when mandating disclosures. For example, when the SEC promulgated its rule governing the Modernization of Regulation S-K Items 101, 103 and 105, the SEC proposed new human capital-related disclosures that are "principles-based" and "cabined with a materiality qualifier." Amanda M. Rose, A Response to Calls for SEC-Mandated ESG Disclosure, 98 Wash. U. L. Rev. ---, at 20 (forthcoming 2021).

4 *See, e.g.*, Modernization of Regulation S-K Items 101, 103 and 105, 85 Fed. Reg. 63726, 63758 (Oct. 8, 2020) (citing those sections as statutory authority).

5 15 U.S.C. §§ 77g(a)(1), 77j(c).

6 15 U.S.C. § 78m(a)(1).

7 Pub. L. 111-203, § 1502, 124 Stat. 1376, 2213 (codified at 15 U.S.C. § 78m(p)).

8 5 U.S.C. § 706(2).

9 *See, e.g.*, *Nat'l Ass'n of Mfrs.* v. *SEC*, 748 F.3d 359, 365–68 (D.C. Cir. 2014) (analyzing challenged informal rule in this manner), *overruled on other grounds*, *Am. Meat Inst*. v. *USDA*, 760 F.3d 18 (D.C. Cir. 2014); *see also Air All. Houston* v. *EPA*, 906 F.3d 1049, 1060–61, 1066–69 (D.C. Cir. 2018)

(per curiam) (vacating rule as *ultra vires*, as well as arbitrary and capricious); *New York* v. *U.S. Dep't of Homeland Security*, 969 F.3d 42, 64–86 (2d Cir. 2020) (enjoining enforcement of rule for same reasons).

10 15 U.S.C. §§ 77g(a)(1), 77j(c).

11 15 U.S.C. § 78m(a)(1).

12 15 U.S.C. § 78b; *cf. Am. Sumatra Tobacco Corp.* v. *SEC*, 110 F.2d 117, 119 (D.C. Cir. 1940) (interpreting the use of "in the public interest" in Section 12(b) of the Exchange Act in the context of the Act's purpose as articulated in Section 2).

13 *See, e.g.*, *AT&T Corp.* v. *FCC*, 236 F.3d 729, 734 (D.C. Cir. 2001).

14 *Motor Vehicle Mfrs. Ass'n* v. *State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 42 (1983).

15 *Nat'l Ass'n of Mfrs.* v. *SEC*, 748 F.3d 359, 369 (D.C. Cir. 2014) (quoting 15 U.S.C. § 78w(a)(2)) *overruled on other grounds*, *Am. Meat Inst*. v. *USDA*, 760 F.3d 18 (D.C. Cir. 2014).

16 *See, e.g.*, *Bus. Roundtable* v. *SEC*, 647 F.3d 1144, 1150, 1152 (D.C. Cir. 2011) (vacating rule because SEC's cost-benefit assessment "did nothing to estimate and quantify the costs it expected companies to incur, nor did [the SEC] claim estimating these costs was not possible . . . ."); *Am. Equity Inv. Life Ins. Co.* v. *SEC*, 613 F.3d 166, 176–77 (D.C. Cir. 2010) (vacating rule because SEC did not conduct "analysis of whether the specific rule will promote efficiency, competition, and capital formation" as required by statute); *Chamber of Commerce* v. *SEC*, 412 F.3d 133, 142–44 (D.C. Cir. 2005) (vacating rule because SEC did not determine "range within which a fund's cost of compliance will fall," which "would be pertinent to its assessment of the effect the condition would have upon efficiency and competition, if not capital formation"); *see also, e.g.*, *Am. Petroleum Inst.* v. *SEC*, 953 F. Supp. 2d 5, 24–25 (D.D.C. 2013) (vacating rule because SEC's statutory interpretation "fundamentally miscalculated the scope of its discretion at critical junctures" and its denial of certain exemptions was arbitrary and capricious).

17 *AT&T Corp.*, 236 F.3d at 734 (quoting *State Farm*, 463 U.S. at 42).

18 Rose, *supra* note 3, at 22.