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Commenters Respond to the SEC's Proposed Rules on Climate-Related Disclosures

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The public comment period for the Securities and Exchange Commission's ("SEC") proposed rules on climate-related disclosures (the "Proposal") closed on June 17, 2022. The Proposal, which was released on March 21, 2022, would require public companies to disclose greenhouse gas ("GHG") emissions and other climate-related information in their registration statements and annual reports. Given its broad reach and complexity, the Proposal, as expected, attracted diverging opinions from various stakeholders.

The SEC received thousands of comments on the Proposal from a range of institutional and individual commenters, including trade associations, corporations, banks and financial institutions, law firms, accounting firms, government officials, academics, and advocacy groups. These market players and thought leaders weighed in on the key topics that have been heavily debated in recent months, such as the SEC's authority to mandate climate-related disclosures, the materiality standard employed to determine the scope of climate-related disclosures, the practicality of measuring Scope 3 GHG emissions, and the overall costs and burdens to companies as well as investors.

SEC's Authority to Compel Climate-Related Disclosures

Several commenters, including legal scholars and lawmakers, addressed the SEC's statutory authority to adopt the rules in the Proposal. Some argued that the SEC lacks an adequate statutory basis to mandate climate-related disclosures in the absence of an explicit directive from Congress. Although two statutes grant the SEC the authority to compel disclosure "necessary or appropriate in the public interest or for the protection of investors,"[1] some commenters felt that the Proposal interpreted this authority too broadly and failed to account for the statutory context, which limited the agency to regulating the disclosure of information tightly linked to companies' financial success. Others similarly argued that there is no causal link between climate risk and financial performance, which limits the agency's power to compel this type of disclosure. Some commenters further asserted that the SEC's reliance on growing investor demand as a way to invoke its authority based on investor protection is flawed given that the investors demanding climate-related information are overwhelmingly institutional asset managers, representing only one segment of the investment industry.

Many commenters also questioned the SEC's expertise in climate-related matters. Some specifically noted that the Clean Air Act of 1974 expressly delegates climate disclosure regulation to the Environmental Protection Agency ("EPA"), and that the EPA already exercises that authority through its Greenhouse Gas Reporting Program ("GHGRP"). According to these commenters, the EPA's authority over climate-related disclosures, particularly GHG emissions, preempts the SEC from claiming any statutory authority because a general principle of federal law holds that more specific laws addressing a subject matter supersede more general laws on that subject.

Opponents of the rule also argued that the Proposal overstepped not only the SEC's statutory authority but also the Constitution by compelling speech in violation of the First Amendment. Highlighting that the First Amendment right to free speech includes the right to refrain from speaking and applies to business entities,[2] these commenters argued that the Proposal would compel corporations to regularly speak on politically charged topics such as climate change. Some commenters argued that, given the concerns about the agency overstepping its authority, as articulated above, the SEC failed to provide the credible justification required of agency-mandated disclosures.

In contrast, other commenters argued that the SEC's broad authority to prescribe rules and regulations is supported by the plain text, legislative history, and recent developments around the federal securities laws. Several commenters highlighted that the SEC has historically mandated the disclosure of environmental information and insisted that the Proposal does not actually "take the capital market disclosure regime into uncharted territory."[3] Commenters argued that the standardized disclosure regime in the Proposal would facilitate investor decision-making, which falls neatly into the ambit of the SEC's authority to act in the interest of the public and investors, and highlighted the connection between increased confidence and willingness to pay among investors and decreased knowledge asymmetries. Commenters further noted that Congress, which has amended the Securities Act numerous times since its inception, could easily have constrained the SEC's ability to compel disclosures on new topics. Its failure to do so, according to these commenters, is evidence of Congress's intent to leave these issues to agency discretion, giving the SEC the flexibility to respond to the changing investment environment.

Materiality Standard

Numerous commenters expressed concerns about the sheer breadth of the Proposal and demanded further clarity on the concept of materiality. Under the Proposal, climate-related risks are defined as "the actual or potential negative impacts of climate-related conditions and events on a registrant's consolidated financial statements, business operations, or value chains," and narrative disclosure is required for "any climate-related risks reasonably likely to have a material impact on the registrant, including on its businesses or consolidated financial statements, which may manifest over the short, medium, and long term" extending up to 50 years.[4] Some commenters argued that the Proposal deviates from the materiality standard that has long been used by the SEC in accordance with Supreme Court precedent: a matter is material if there is a substantial likelihood that a reasonable investor would consider it important in determining whether to buy or sell securities or how to vote.[5]

One commenter, for example, argued that the SEC is departing from traditional materiality by "introducing a novel temporal dimension not tied to a reasonable investor's investment decision."[6] According to this comment, it would be difficult for a company to rule out the possibility of a material impact from climate change on any of its properties or operations over a time horizon as long as 50 years. Other commenters similarly pointed out that the Proposal is extremely broad and covers climate-related risks that are currently immaterial but could be material in the future. These commenters stated that expanding the materiality standard could invite negative consequences for investors and companies by inundating investors with immaterial information that may be misunderstood to be material, and by exposing companies to unnecessary litigation risks.

Scope 3 Emissions Disclosure Requirements

As expected, the SEC's proposed requirement that companies disclose Scope 3 GHG emissions if material or if the company has established a reduction goal that includes Scope 3 emissions generated a heated debate among industry leaders, advocacy groups, and other stakeholders. The most significant push-back came from small and medium-sized businesses and farmers, who called on the SEC to remove the Scope 3 emissions disclosure in its entirety or, alternatively, to provide carve-outs for certain sectors. The National Association of Manufacturers ("NAM"), for example, argued that the SEC's proposed Scope 3 reporting requirement is simply unattainable, as many small and privately held businesses do not yet track their Scope 1 and Scope 2 emissions, limiting the ability of larger public companies to include such data in their Scope 3 calculations. According to NAM, even if public companies could access such data from their value chain partners, there is no guarantee that such data would be accurate or reliable given that many smaller entities do not currently have the resources to dedicate significant funds toward the equipment and expertise necessary to gain a complete picture of their emissions.

Nasdaq also weighed in on Scope 3 disclosure requirements, pointing out that the Proposal "may have unintended consequences to 'small entities' if issuers avoid working with smaller suppliers because they cannot provide the necessary data for issuers to report their Scope 3 emissions."[7] Nasdaq referenced its 2022 survey data, which revealed that 99% of respondents that would be subject to the SEC's Scope 3 requirements viewed those requirements as extremely challenging, if not impossible, to satisfy due to the lack of necessary information from third parties in a company's value chain. In particular, Nasdaq expressed concerns that the Scope 3 disclosure requirements would steer reporting companies away from smaller women, minority, and veteran-owned suppliers. Nasdaq also noted that increased compliance costs would harm the Initial Public Offering ("IPO") market by discouraging private companies from going public, and have broader consequences for the U.S. economy during a time of heightened market volatility and inflation.

On the other hand, several commenters, including the United Nations-convened Net-Zero Asset Owner Alliance ("AOA"), argued that the inclusion of Scope 3 emissions is necessary to show the true and full scope of emissions attributable to a company. These commenters claimed that without the Scope 3 value chain disclosures, companies can simply shift their polluting activities to other parts of the value chain that are not subject to audits. As a result, their products could continue to contribute to environmental degradation while their disclosures highlight emission reductions.

A number of commenters, including the Institute for Energy Economics and Financial Analysis ("IEEFA") and Private Equity Stakeholder Project ("PESP"), took a step further and urged the SEC to require all companies to report Scope 3 emissions. Noting that the majority of companies' GHG emissions stem from Scope 3, these commenters argued that the SEC should not allow registrants to make their own determinations as to whether Scope 3 emissions are material and therefore subject to disclosure. Rather, the commenters said that the SEC should require disclosure of Scope 3 emissions by all registrants and provide a lengthier timeline for smaller reporting companies ("SRCs") to ensure that investors are provided with a broader context that would allow them to consider the entire value chain of a reporting company's operations.

Safe Harbors

Another issue raised by several commenters centered on whether the Proposal affords meaningful safe harbors for all climate-related disclosures. Although the Proposal currently provides a liability safe harbor for disclosures on Scope 3 GHG emissions, some commenters recommended that the SEC extend similar protection to other disclosures. In particular, the commenters urged the SEC to add new safe harbors where the disclosure is forward-looking, the registrant would need to rely on third-party information, or the methods and standards used in disclosure are evolving or subject to change. Many commenters argued that the SEC's reference to the safe harbor for forward-looking statements under the Private Securities Litigation Reform Act of 1995 ("PSLRA")[8] is insufficient, especially because the PSLRA safe harbor is unavailable for disclosures in IPOs as well as disclosures in financial statements and related notes. These commenters expressed concerns that the Proposal, in its current form, would create uncertainty for companies about the level of disclosure and expose them to significant litigation and enforcement risks. According to one commenter, "[t]here is no reason to ask private plaintiff-side lawyers to the table while markets and regulators address the complicated and critical topic of developing climate-related disclosure methods and standards."[9]

Financial Statement Disclosure Requirements

With respect to financial statement disclosures, several commenters, including accounting firms, raised concerns about the Proposal's requirement that companies provide certain climate-related information on a line-item basis unless the impact on the line item is less than 1% of the total line item for the relevant fiscal year. Many commenters argued that the proposed 1% disclosure threshold is unusually low, and warned that companies would likely not be able to design and implement procedures enabling them to capture and report such highly specific information about costs associated with severe weather events and other natural conditions. Moreover, some commenters asserted that even if companies could, with sufficient time and resources, measure and gather climate-change impacts on financial line items, it is unclear why a reasonable investor would find this granularity of information necessary for decision-making purposes. In light of these concerns, some commenters recommended the SEC to increase the line item threshold to 5% or even 10%.

Company Readiness vs. Immediate Need for Information

Some commenters also focused on companies' overall preparedness to provide specific climate-related disclosures in their SEC filings. Relying on its survey of 300 senior finance, legal, and sustainability officers, Deloitte commented that while companies have made progress in integrating environmental, social, and governance ("ESG") factors into their core business activities, many challenges remain in providing reliable and consistent ESG disclosures, including GHG emissions disclosures. For one, companies varied widely in their preparedness for GHG emissions reporting, with only 31% of Deloitte's respondents stating that they are prepared to disclose Scope 3 emissions. In terms of resources, less than a quarter of survey respondents had a team dedicated to ESG topics, with 82% of senior executives not confident that their organization was sufficiently staffed to meet the demands of increased ESG disclosures.

Others, however, highlighted an immediate need for climate-related information from companies, given the imminent impacts of climate change across the globe. Some commenters emphasized that the Proposal is necessary to address the current climate-related disclosure gap, noting that voluntary disclosures, while commendable, are often incomplete, inconsistent, and reported in a wide array of qualitative and quantitative formats and media, making it extremely difficult for investors to accurately price climate-related risks across companies and adjust portfolio capital allocation. According to these commenters, the SEC's Proposal to mandate consistent, comparable, and audited disclosures on public companies will enable investors to gauge a company's exposure to climate-related risks.

What to Expect Next

Under the notice-and-comment rulemaking requirements of the Administrative Procedure Act ("APA"), the SEC would be required to address "materially cogent" comments in a final rule.[10] According to the SEC's recently released 2022 Regulatory Agenda, the agency expects to issue the final rule in October.[11] The original SEC vote on the Proposal was 3 to 1, with the agency's three Democratic-leaning members voting in its favor, and the sole Republican commissioner, Hester Peirce, dissenting. While a final rule will certainly be issued, it is unclear how significantly the SEC will amend the Proposal. Further, we anticipate that, given many of the comments opposing the SEC's proposed climate rulemaking, the rule will be challenged in court.

Regardless, companies should be prepared to disclose climate-related information and metrics in accordance with the Proposal. With similar legislative initiatives taking place across the globe, particularly in Europe, the mandatory climate disclosure rules are on their way. Companies that have already begun collecting and disclosing climate-related information must continue to evaluate their current reporting practices against the new requirements and identify areas where they have previously failed to report or reported insufficiently. With the SEC's increasing scrutiny, companies should also be more intentional — and cautious — in setting climate-related targets or goals. Finally, companies need to act now to ensure appropriate expertise and oversight at the board level, as well as appropriate management-level expertise and oversight.

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If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings Washington, D.C. lawyers:

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1 Securities Act of 1933, §§ 7, 10, 19(a); Securities Exchange Act of 1934, §§ 3(b), 12, 13, 14, 15(d), 23(a).

2 *See, e.g.*, Wooley v. Maynard, 430 U.S. 705, 714 (1977).

3 Comment submitted by Jill E. Fisch, University of Pennsylvania Carey Law School, and George S. Georgiev, Emory University School of Law (June 6, 2022).

4 The Enhancement and Standardization of Climate-Related Disclosures for Investors, 17 CFR §§ 210, 229, 232, 239, and 249 (proposed March 21, 2022).

5 *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988); TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 449 (1977).

6 Comment submitted by Davis Polk & Wardwell LLP (June 9, 2022).

7 Comment submitted by Nasdaq, Inc. (June 14, 2022).

8 *See* Securities Act of 1933, § 27A; Securities Exchange Act of 1934, § 21E.

9 Comment submitted by Cleary Gottlieb Steen & Hamilton LLP (June 16, 2022).

10 *See, e.g.*, United States v. Nova Scotia Food Products Corp., 568 F.2d 240, 252 (2d Cir. 1977).

11 Office of Information and Regulatory Affairs, Office of Management and Budget, Agency Rule List - Spring 2022: Securities and Exchange Commission, https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202204&RIN=3235-AM87.