Securities and Exchange Commission Enters the Climate Debate

By Kenneth J. Warren / *The Legal Intelligencer*

The words “climate change” trigger vigorous debate. Many Americans view alterations to global climate as an existential threat to our planet and demand immediate implementation of mitigation and adaptation measures with potential far-reaching consequences to our economy. Yet others treat climate change as if it were a hoax, an exaggerated prediction from scientists with an allegedly political agenda, or an international problem over which our nation can have scant influence. These competing views complicate financial disclosure regulation because imposing climate-related disclosure obligations on public companies may necessitate acknowledging that climate risks are real and amenable to evaluation.

In a proposed rule released on March 21 for public comment, Enhancement and Standardization of Climate-Related Disclosures for Investors, the Securities and Exchange Commission (SEC) set forth detailed requirements for disclosure of climate-related information in registrations and reports filed with the commission. The three Democrat SEC commissioners approved the proposed rule over the fervent opposition of the sole Republican commissioner. The SEC explained that its proposed rule would protect investors by providing consistent, comparable and reliable information useful for evaluating the impact of climate-related risks on current and potential investments.

On April 5, 19 Republican senators co-signed a letter to the SEC requesting that the proposal be withdrawn. They contended that the rule is not within the SEC’s mission, does not address information material to investors, is unnecessary in light of existing securities regulations and voluntary disclosures, violates the First Amendment prohibition against compelled speech and would impose enormous costs for employers. Sen. Joe Manchin has separately expressed his opposition. Clearly, the SEC is in for a fight if it adopts the regulation at the conclusion of the comment period.

The SEC Proposal

To evaluate the proposed rule, it is first useful to highlight its key provisions. Public companies would be required to disclose in their registration statements and annual Form 10-Ks financial risks and impacts to them from climate change. The disclosure would include climate-related risks that over the short, medium or long-term are reasonably likely to have material impacts on the company's business operations, strategy and outlook, its value chains or its financial statements. The company would be obligated to include climate-related metrics and an associated explanatory note in its financial statements. Disclosure of the manner of board oversight of climate risks would also be mandated.

The SEC suggested that disclosure of climate risks would not be burdensome because its proposed requirements adopt the 2017 recommendations of the Task Force on Climate-Related Financial Disclosures. Many companies already disclose the present and anticipated financial impact of severe weather events and other climate risks as well as the risks associated with transitioning to a less carbon-intensive operation. Large companies frequently include this information in publicly available sustainability reports. Yet as the SEC recognized, because filing information with the SEC creates attendant enforcement risks, a filing requirement provides an incentive for greater accuracy.

The SEC proposal would also require companies to disclose their GHG emissions. Adhering closely to the GHG protocol, the proposed rule divides this disclosure obligation into three "Scopes." Scope 1 consists of the quantity of the company's direct GHG emissions such as those created by burning fossil fuels or operating machinery.

Indirect GHG emissions from purchased energy such as electricity constitute Scope 2. Disclosure of Scope 1 and Scope 2 would be mandatory for all registered companies. Large companies would be required to verify their disclosures by submitting an attestation report by an independent GHG emissions attestation provider.

Scope 3 is the most controversial. It includes indirect emissions from upstream and downstream activities in a registrant's value chain such as the company's suppliers or users of its products or services. Value chain emissions may far exceed the magnitude of the company's own emissions. Acknowledging the difficulty a company may face in obtaining accurate information from third-party suppliers or product users, the SEC proposal would mandate Scope 3 disclosures only for large companies and for those companies that have set a GHG emissions target or goal that includes Scope 3 emissions. In addition, the Scope 3 disclosure obligation is phased-in, limited to material information, and protected by a safe harbor that does not require attestation.

The Need for Additional Regulation

Opponents of the proposal contend that existing SEC regulations already adequately require disclosure of material risks from climate change. For example, provisions of Regulation S-K require disclosure of material events and uncertainties (Item 303) and material factors that make an investment risky (Item 105). The commission majority, however, disagreed that these and other existing Items alone provide sufficient accurate information regarding climate risks. Rather, they concluded that requiring a standard presentation of more-detailed climate-related information would assist investors in evaluating the risks and impacts of climate change to a company's financial condition and outlook.

Materiality

Opponents of the proposed rule argue that the SEC may only require disclosure of information material to investors. Courts consider an item material if there is a substantial likelihood that a reasonable investor would consider the information important in deciding how to vote or make an investment decision. According to the proposal's opponents, much of the information addressed in the rule is not material or capable of being accurately quantified or characterized. The SEC counters that it may require disclosures in the public interest whether or not the information is material. Moreover, the proposed rule mandates disclosure without regard to materiality for only for Scope 1 and Scope 2 disclosures; materiality is an element of other proposed disclosure requirements.

Questioning the materiality of climate-related information ignores the increasing prevalence of weather-related disasters and the scientific consensus that climate change is occurring. Earlier this week, the International Panel on Climate Change (IPCC) Working Group III issued its report emphasizing that immediate actions are needed to avoid dire social and economic consequences from elevated global temperatures, heightened sea level, and increased frequency and severity of droughts, floods, storms and other climate-related events. Sound science supports the conclusion that physical climate risks to a company's operations and its costs of transitioning to processes or suppliers with lower GHG emissions may be material to a reasonable investor.

But whether the SEC may properly mandate Scope 1 and 2 disclosures without regard to materiality is less clear. The SEC explained that these GHG emission disclosures serve as a proxy for the climate-related risks a company faces. The strength of the SEC's position may depend on its ability to show a connection between GHG emissions and financial risks or valuation. Evidence that GHG emissions are a proxy for higher costs of capital, increased costs of transitioning to and operating in a low-carbon economy, or a need for capital allocations to meet regulatory consumer or investor demands would help show the proposal is in the public interest.

Although the SEC bases its proposed rule on protection of investors, opponents assert that it actually seeks to promote environmental goals. To be sure, EPA regulations employ disclosure to reduce emissions as an alternative or supplement to setting standards or imposing direct pollutant limitations. For example, the toxics release inventory (TRI) requires facilities in certain industry sectors to report annually the quantity of each toxic chemical released to the environment or managed through recycling, energy recovery and treatment. The EPA's GHG reporting program mandates disclosure for large sources of GHG emissions and suppliers. These programs encourage emissions reduction. But the validity of the SEC's proposed rule will likely depend on whether it falls within its own statutory authority.

It will be interesting to see what portions of the proposal rule are adopted by the SEC and sustained after likely challenges. In the meanwhile, in preparation for issuance of the final rule, public companies would be well-advised to examine data on their own GHG emissions and assess indirect emissions from companies in their supply chain and users of their products or services.

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