Professional Perspective

Climate Risk Compliance & SEC Enforcement

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The Securities and Exchange Commission has demonstrated that enforcement and regulation of disclosures relating to environmental, social, and governance (ESG) and climate risks are priorities. On March 21, 2022, the SEC proposed rule amendments requiring public companies (issuers) to include certain climate-related information in their public disclosure filings (the issuer rule).

On May 25, 2022 the SEC published a new proposed rule requiring certain investment advisers and investment companies to make ESG disclosures (the investor rule). The SEC also recently settled charges against BNY Mellon Investment Management (BNYM) relating to the investment adviser's ESG disclosures, and charged Vale, SA, a Brazilian mining company, for allegedly making false and misleading claims regarding the safety of a Brazilian dam prior to its collapse.

Although many questions remain as to the final form of the proposed rules, and whether, if adopted, they'll be upheld in the courts, this appears to be the beginning of a new wave of enforcement, and the actions against BNYM and Vale show that the policing of ESG-related disclosures and curbing "greenwashing" are already high priorities of the SEC.

Proposed Rules

The issuer rule would require domestic and foreign issuers to include in their registration statements and periodic reports information relating to climate-related risks, including business impacts and risk management processes, as well as information relating to greenhouse gas (GHG) emissions and climate-related metrics, planning and goals, among other information.

The investor rule would establish disclosure requirements for funds and advisers that market themselves as having an ESG focus. Those funds and advisers would be required to provide more specific disclosures in fund prospectuses, annual reports, and adviser brochures based on the ESG strategies they pursue. For example, funds focusing on the consideration of environmental factors generally would be required to disclose the greenhouse gas emissions associated with their portfolio investments.

The issuer rule was open for public comments through June 17, 2022. The investor rule is open for public comments through August 16, 2022—a deadline that could be extended. After the respective comment periods end, the SEC will consider whether to make further amendments and adopt the proposed rules.

It appears that the SEC is endeavoring to finalize and adopt the issuer rule, or some version of it, before the end of 2022. However, even if the issuer rule and the investor rule are adopted in current form, there will undoubtably be legal challenges that create further uncertainty as to whether and how much of the proposed rules will survive judicial review.

Litigation Certain

Despite the SEC's reference to widespread support for the climate disclosures it has recommended, and significant momentum favoring adoption of the proposed rules in some quarters, the proposed rules will face strong litigation headwinds. Two sources provide an illustrative roadmap for the opposition—first, the dissenting statements of Commissioner Hester Pierce, who opposed the proposed rules, and second, the comments submitted in response to the March 2021 call for comments on proposed climate disclosures by then-Acting Chair Allison Herren Lee.

Two overriding issues predominate: a statutory objection, on the grounds that the Commission is exceeding its limited statutory authority in proposing amendments to Regulations S-K and S-X, and a constitutional objection, on the grounds that the compelled speech required by the proposed amendments violates the First Amendment of the US Constitution.

Statutory Challenge

Objectors to the proposed rules have already argued that the proposed mandatory climate disclosures are neither "necessary" nor "appropriate" to ensure investor protection and fairness in the securities markets, and therefore exceeds the SEC's rule-making authority pursuant to Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), which states that the Commission may adopt rules and regulations "as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security …"

For example, in a letter on behalf of himself and 15 other state attorneys general submitted in June 2021, West Virginia Attorney General Patrick Morrisey noted that "the governing statutes make clear that legitimate mandatory disclosures are those required to protect investors from inflated prices and fraud," which letter argues that climate-change disclosures—such as those required by the proposed rules—would not meet that standard.

This argument derives some support from the fact that there is no explicit statute authorizing the proposed rules (although the argument may be stronger with respect to the issuer rule because the Commission does arguably have more regulatory authority under the statutes regulating investment companies and advisers to justify the investor rule).

Indeed, in her comments on the Issuer Rule, Pierce pointed to the Supreme Court's prior statement in Util. Air Regulatory Grp. v. EPA, 573 U.S. 302, 324 (2014)—ironically, an environmental regulation case involving the Environmental Protection Agency (EPA)—with some force: "When an agency claims to discover in a long-extant statute an unheralded power to regulate 'a significant portion of the American economy,'" Pierce quoted, "we typically greet its announcement with a measure of skepticism. We expect Congress to speak clearly if it wishes to assign to an agency decisions of vast 'economic and political significance.'"

Given the Supreme Court's current makeup, the limits of the SEC's statutory authority to promulgate the proposed rules will certainly be tested in court. Indeed, some justices have expressed concern for separation of powers particularly in the context of agency rule-making without clear statutory authorization. See Nat'l Fed'n of Indep. Bus. v. Dep't of Labor, Occupational Safety & Health Admin., 142 S. Ct. 661, 667 (2022) (Per Curium) (Gorsuch, J., Thomas, J., and Alito, J., concurring); Gundy v. United States, 139 S. Ct. 2116, 2141 (2019) (Gorsuch, J., dissenting).

The Supreme Court may be asked again to apply the "major questions doctrine," which provides that regulatory initiatives with significant economic or societal impacts must be explicitly articulated by Congress. If the "major questions doctrine" supported the court's intervention in the national vaccine mandate, the SEC's climate and ESG disclosure mandates (with less immediately at stake than a national pandemic) may have a similar fate.

Indeed, the Supreme Court's recent decision in *West Virginia v. EPA*, casts further doubt on the proposed rules surviving a challenge based on the application of the major questions doctrine. The Supreme Court applied the major questions doctrine and concluded that the EPA exceeded its authority under the Clean Air Act by establishing emission caps in the Clean Power Plan that would have required a shift in electrical generation from coal to cleaner sources such as natural gas, wind and solar. The Court pointed to the fact that the Clean Power Plan represented a departure from 50 years of regulation under the Clean Air Act and would have implemented a system that Congress has repeatedly refused to adopt. The decision lends further support for the argument that the SEC is similarly discovering a newfound power to regulate issues relating to climate change and emissions, which issues were not traditionally regulated by the SEC in the new manner proposed, under long-standing statutory authority.

Constitutional Challenge

Opponents of the Proposed Rules have also raised First Amendment concerns arising from the compulsion of statements by issuers and advisers, pointing to courts overturning prior regulation by the SEC that would compel speech in violation of the First Amendment. The SEC previously sought to require that issuers using certain minerals from the Democratic Republic of the Congo (DRC) (i.e., gold, tantalum, tin, and tungsten) file a statement that the minerals were not "DRC conflict free" both on their websites and in filings with the SEC.

That particular compelled statement—despite the explicit statutory authorization from the Dodd-Frank Act, which does not exist for the proposed rules—was deemed to be unconstitutional. Nat'l Ass'n of Manufacturers v. S.E.C., 800 F.3d 518, 553 (D.C. Cir. 2015). The court concluded that, even assuming the government had a sufficient interest in requiring companies to make the compelled statement (i.e., to lessen the humanitarian crisis in the DRC), the SEC failed to carry its burden of proving that the compelled statement was effective in achieving that objective.

Furthermore, the court concluded that even if the government interest were sufficient, and even if the chosen means to achieve the objective was effective, the statement was still not "purely factual and uncontroversial."

Given that the proposed rules would require disclosures and attestations regarding GHG emissions and climate change risks and impacts, among other topics—without express statutory authorization such as that found in the Dodd-Frank Act for the "DRC conflict free" regulation which was nonetheless ruled unconstitutional—there are questions as to whether the proposed rules will survive judicial review. Ultimately, a court will decide whether the government's interest in the proposed rules is of sufficient weight, whether the required disclosures are tailored to achieve that purpose, and whether the resulting statements compelled are "purely factual and uncontroversial."

Regulatory Framework

Companies must also grapple with the shifting regulatory framework on climate impacts, in particular with respect to GHG emissions. Although the issuer rule only requires disclosures by public companies and the investor rule only requires disclosures in certain situations, they will nonetheless impact private companies. The issuer Rule will reach vendors, suppliers and even customers of larger public companies, as those issuers seek more information regarding upstream and downstream GHG emissions resulting from their business operations. The investor rule might also reach private companies to the extent they have ESG-focused funds as investors or are part of an investment adviser's ESG-related strategy.

Under the issuer rule, issuers would be required to disclose quantitative information about their own direct GHG emissions (Scope 1), namely those directly generated by the company's facilities and vehicles; and indirect GHG emissions (Scope 2), namely those generated to create the electricity/energy consumed by the company in its operations. Certain issuers would also be required to disclose quantitative information about indirect emissions from upstream and downstream activities in the issuer's value chain (Scope 3) if either material, or the issuer has set a GHG emission target that includes Scope 3 emissions.

That would have wide-ranging implications as any issuers required to make disclosures regarding Scope 3 emissions would seek information regarding the GHG emissions and operations of the participants in their value chain in order to assess the materiality of their Scope 3 emissions. This materiality assessment would require issuers to attempt to collect or estimate GHG emissions information from third parties, regardless of whether those third parties are publicly traded and/or obligated to make GHG disclosures themselves.

Many issuers are already making GHG emissions disclosures to other regulatory agencies, and will have to carefully consider the consistency of reporting under different and evolving standards. For example, many companies with significant emissions sources are already required to report on GHG emissions to the EPA and/or state regulatory agencies. Although the SEC notes that its proposed reporting requirements would be consistent with the EPA's 2009 Mandatory Reporting of Greenhouse Gases Rule (40 C.F.R.Part 98), issuers will likely not be able to rely on the same reporting.

That is because the EPA rule generally requires facility-specific reporting, but the issuer rule requires organizational reporting. Additionally, any reporting required to be made to state agencies may not be consistent with the GHG Protocol methodology that the issuer rule would adopt.

As a result, companies may need to collect more emissions-related data than already compiled for the EPA and state agencies in order to comply with SEC reporting requirements. Further muddying the water is the Supreme Court's decision in *West Virginia v. EPA* limiting the EPA's regulation of GHG emissions, and raising questions as to any federal regulations relating to climate change and GHG emissions absent clear Congressional authority. The SEC's issuer rule would also extend to more companies than are already reporting GHG emissions to the EPA. In either instance, this means higher costs for companies both to collect the data needed for reporting and to compile that data into unique reports for each overlapping reporting requirement.

In particular, energy companies will face unique challenges as they also disclose information relating to GHG emissions to the Federal Energy Regulatory Commission (FERC). But the FERC's GHG policy is in transition. In February 2022, the FERC approved an Updated Policy Statement on Certification of New Interstate Natural Gas Facilities and the Interim Policy Statement (GHG Policy), which would have significantly changed the manner in which FERC quantified GHG emissions.

Notably, the GHG policy stated that the FERC will follow the Council on Environmental Quality (CEQ) regulations to quantify GHG emissions. But those regulations are also in flux, as CEQ rescinded its 2019 draft guidance on the consideration of GHG emissions in February 2021, and is now reviewing, for revision and update, its 2016 final guidance. However, on March 24, 2022, the FERC issued an order making the Updated Policy Statement and GHG Policy draft policies and inviting comments and reply comments over the next 60 days. The final form of the FERC's new policies (and the CEQ regulations) remains unclear, and, as with the SEC's Proposed Rules and the EPA's regulations, there will likely be legal challenges.

For international companies, there are also global climate disclosure standards to consider. There is an ongoing effort to consolidate global reporting standards, as the International Financial Reporting Standards (IFRS) Foundation formed a new International Sustainability Standards Board (ISSB) that will develop a comprehensive global baseline for sustainability disclosure standards.

The ISSB developed prototype disclosure requirements from the joint efforts of a number of organizations, including the Task Force on Climate-Related Financial Disclosures (TCFD)—whose "four pillar" disclosure framework heavily influenced the SEC's proposed rules—and with the support of the International Organization of Securities Commissions (IOSCO) regulators.

The standards being developed by the ISSB—to be known as the IFRS Sustainability Disclosure Standards—are intended to be compatible with the IFRS Accounting Standards used in most jurisdictions other than the US. While the SEC is certainly aware of the ISSB standards and may take such standards into consideration in the future, it appears that the SEC intends to develop its own standards rather than adopt any international standard. Again, this means that companies may have to collect additional data or quantify and report it differently for the SEC than for international securities commissions.

What Companies Can Do Now

Although the timing and eventual fate of the proposed rules are uncertain, we expect both regulators and investors to continue to focus on and advocate for increased disclosures on ESG and climate-related risks. SEC chair Gary Gensler recently emphasized that climate disclosures are already happening and his belief that the proposed rules are consistent with the SEC's central mission to protect investors, maintain fair, orderly, and efficient markets and facilitate capital formation.

The adopted version of the proposed rules may be delayed or scaled down in the future, whether in response to comments or legal challenges, or the Supreme Court's decision in *West Virginia v. EPA*, but it appears some version of the proposed rules are likely to be enacted eventually. Given the uncertainty posed by the evolving standards for climate disclosures and legal challenges to regulations on climate change, ensuring consistency and compliance across all reporting and disclosures of climate change issues, especially GHG emissions, will require careful scrutiny and coordination between a company's legal, reporting, risk management and corporate communications groups.For example, the sample comment letter provided by the SEC in September 2021 indicated that the SEC might ask for an explanation if a company provides more climate-related disclosures in an ESG report or CSR report than in its SEC filing.

Regardless of the outcome of the proposed rules, it is clear that with the SEC's launch of an ESG enforcement task force in March 2021 and the recent actions against BNYM and Vale, companies should expect a continued focus on regulation and enforcement actions relating to ESG disclosures. With that in mind, companies should consider the following steps to plan for a future of enhanced regulation on ESG and climate change impacts:

- Determine whether sufficient resources are dedicated to monitoring and evaluating climate-related risks.

- Determine whether sufficient management and board expertise exists to assess climate-related risks.

- Take steps to ensure collection and evaluation of appropriate data, including GHG emissions data, for purposes of monitoring and evaluating climate-related risks, as well as for reporting Scope 1 and 2 emissions (and, where relevant, Scope 3 emissions).

- Determine whether financial and audit teams have sufficient expertise to provide guidance and management of the changing financial statement presentations that would be required under the proposed rules.

- Review internal controls and processes to ensure consistency and coordination of reporting across regulatory filings, corporate social responsibility (CSR) reports and company statements on climate related-risks and GHG emissions.

- Determine whether appropriate policies, procedures, and controls are in place to monitor and evaluate performance against sustainability or ESG plans and targets, both qualitatively and quantitatively.

- If GHG emissions are already tracked, determine what additional data is necessary to comply with the SEC's disclosure requirements and what additional processes are needed to track GHG emissions.

- For larger companies that may be required to make disclosures regarding Scope 3 emissions, consider whether and how to collect emissions data from private companies both upstream and downstream in the value chain and engage with key suppliers, vendors, and customers regarding that process.

- For private companies in the value chain of large public companies, consider what processes are needed to track emissions to provide the data that large public companies will seek for Scope 3 emissions.

- For private companies, consider whether your investors are going to be subject to the investor rule and thus require heightened disclosures from you.

- Carefully vet all public statements regarding climate risk to avoid material misstatements or material omissions that could elicit either government enforcement action or private securities litigation.