Evaluating Challenges To SEC's ESG Disclosure Proposal

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Introduction

Many companies now publish sustainability reports. Their managers are voluntarily trying to meet investor and consumer demand for climate-related disclosures.

The U.S. Securities and Exchange Commission says it will propose new regulations mandating such disclosures from, at least, public companies in October.

But not everyone agrees that is a good idea. Some say the SEC lacks authority to adopt such rules.

We examine arguments against more mandatory SEC regulations.

Background

Since 2010, the SEC has provided interpretative guidance for public companies regarding how its existing disclosure requirements apply to climate change matters.[1]

In May, President Joe Biden called for further action. In an executive order issued that month, the president announced a governmentwide strategy to address climate-related financial risks.[2]

As part of this, the SEC is considering mandatory climate-related disclosure requirements. The SEC projects it will release the proposed rulemaking in October.[3]

To inform this proposed rule, the SEC requested public comment on 15 detailed questions regarding potential changes to climate risk reporting, and certain environmental, social and governance, or ESG, disclosures more generally.[4]

The SEC received over 550 unique comment letters, including one in support of broad and comprehensive climate requirements from a group of attorneys general, led by California Attorney General Rob Bonta and New York

Attorney General Letitia James.[5]

After the public comment period ended, SEC Chairman Gary Gensler publicly said he had asked SEC staff to develop a mandatory climate risk disclosure proposal for the commission by the end of the year.[6]

He also identified what he wanted staff to consider when drafting these disclosures. Gensler's requests included:

- Whether these disclosures should be filed in the Form 10-K or elsewhere;
- How companies might disclose Scope 1, Scope 2 and Scope 3 emissions;
- If there should be certain metrics for specific industries, such as banking, insurance or transportation;
- If fund managers should disclose the criteria and underlying data they use; and
- If anything about the Names Rule needs to changed.[7]

According to the SEC's public comments, and a recent speech by Gensler, companies can expect the SEC to finalize expanded federal disclosure and reporting regulations regarding climate-related risks in the next year.

Challenges to Mandatory Climate-Related Risk Disclosures

In a speech in late July, Gensler said that three out of four of the 550 unique responses the SEC received in its comment period supported mandatory climate disclosure rules.[8]

That means that a good many comments the SEC received opposed more mandatory regulations.

Opponents to more SEC financial reporting mandates included corporations, states and nonprofit organizations.

Some have a track record of challenging government and administrative actions.

Just as one group of state attorneys general submitted comments supporting broad mandatory disclosures,[9] a different set of attorneys generals, led by West Virginia Attorney General Patrick Morrisey, submitted a letter against.

These state officials urged the commission to:

> [R]emain focused on its historic mission and role rather than seeking to expand its congressional mandate into unrelated social matters — particularly where companies are showing themselves adept to provide the type of information that customers and investors actually demand in this area.[10]

A number of commenters suggested that if the SEC attempts to move beyond the 2010 guidance to impose mandatory regulation, litigation will follow.

Some of the arguments made include the following.

Constitutional Claims: Compelled Speech

Policy groups, like the Competitive Enterprise Institute, claim that the call for mandatory climate risk disclosures is "climate change activism in a finance regulation wrapper, rather than a serious effort to foster better price discovery or remedy any real damage to investors."[11]

They argue that the First Amendment's compelled-speech doctrine means that the government cannot force an individual, group or corporation to express specific beliefs.

The First Amendment not only prevents the government from punishing a person for his or her speech, it also prevents the government from punishing a person for refusing to speak in a certain way.

On the compelled-speech doctrine, the U.S. Supreme Court said in 1943 in West Virginia State Board of Education v. Barnette:

> If there is any fixed star in our constitutional constellation, it is that no official, high or petty, can prescribe what shall be orthodox in politics, nationalism, religion, or other matters of opinion or force citizens to confess by word or act their faith therein.[12]

If corporations are required to comply with these ESG disclosure requirements, opponents say that some corporations would be forced to make remarks about their operations that are subjective or disparaging.

This is something the First Amendment may protect against.

The letter from state attorneys general led by Morrisey challenged the SEC by stating:

> Responding to purported public demand for increased information about public companies' climate measures is not a sufficient government interest to compel speech.[13]

When promulgating any climate-related disclosures regulations, the SEC will need to tread carefully.

The U.S. Court of Appeals for the District of Columbia Circuit previously addressed a similar issue. In National Association of Manufacturers v. SEC, the court partially invalidated the Dodd-Frank Act's conflict minerals disclosure requirement on compelled-speech grounds.[14]

The court found that the compelled speech did not sufficiently advance the SEC's mission of "preventing consumer deception."[15]

"By compelling an issuer to confess blood on its hands," the court wrote, "the statute interferes with that exercise of the freedom of speech under the First Amendment."

Nevertheless, the NAM case was not unanimous. U.S. Circuit Judge Srikanth Srinivasan dissented, writing:

> Issues of securities must make all sorts of disclosures about their products for the benefit of the investing public. No one thinks that garden-variety disclosure obligations of that ilk raise a significant First Amendment problem. So here.[16]

Statutory Authority: "Necessary and Appropriate" and "Materiality" Requirement

The Constitution aside, another issue raised is whether the SEC's existing statutory authority is sufficient to require detailed disclosure of climate-related metrics and other ESG information.

In the case of conflict minerals, the SEC successfully navigated arguments about its statutory authority to issue disclosure regulations — before the D.C. Circuit held them unconstitutional.[17]

Absent new legislation, the commission's authority to require ongoing public reporting will be defined by Section 13(a) of the Exchange Act:

> Every issuer of a security registered pursuant to section 781 of this title shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security[,] … (1) such information and documents … as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 781 of this title … [and] (2) such annual reports … and such quarterly reports … as the Commission may prescribe.[18]

This is a threshold requirement that every rule and regulation concerning public reporting must satisfy.

In addition, SEC Rule 10b-5 refers to the need for materiality:

> The term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered.[19]

This definition reflects the Supreme Court's interpretation of "material" in its 1976 decision in TSC Industries Inc. v. Northway Inc.:

> [T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[20]

Opponents to mandatory climate risk disclosure argue it is neither necessary and appropriate, nor material. Therefore, such regulations would be unlawful.

When the Supreme Court interpreted what is material for purposes of Rule 10b-5 in its 1988 Basic Inc. v. Levinson decision, it outlined an objective standard of significance to past and future performance and the value of the security.[21]

In its comment letter, the Competitive Enterprise Institute thus argued that "in a rapidly changing and competitive market, no one has enough information to plan intelligently much further ahead than five or perhaps ten years," and that "the fact that some market participants might want access to additional information from public firms should not make them automatically entitled to receive it at those firms' expense."[22]
In the litigation over the SEC's conflict mineral regulations, the SEC successfully overcame arguments that the disclosures were not necessary or appropriate.[23]

The Dodd-Frank Act had, however, mandated those regulations.

To justify mandatory climate and other ESG disclosures, the SEC will need to demonstrate how particular requirements will "advance the purposes of the securities laws" and "promote efficiency, competition, and capital formation,"[24] in the words of the D.C. Circuit's National Association of Manufacturers ruling.

APA Procedure: Arbitrary and Capricious
Although the SEC has not yet proposed mandatory disclosures and attempted to explain reasons for them, commenters questioned whether the SEC can ultimately justify such a mandate for public companies, given prior policy.

Section 706(2)(A) of the Administrative Procedure Act instructs courts reviewing regulations to invalidate agency action found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."

Courts can vacate agency rules if they find the underlying rationale or factual assertions to be inconsistent, unsupported or unreasonable.

To justify a break with long-standing policy, the commission will need to confront past findings and provide good reasons, grounded in the statutory factors, for departing from them.

The commission does possess broad powers to require issuers of widely held securities to make statements on many topics when there is investor demand.

Under the current principles-based approach, however, regulated entities use this definition to determine on a case-by-case basis whether a reasonable investor would consider the disclosure relevant.

Some commenters claim that the SEC has not yet articulated why the current principles-based system of climate-related and other ESG disclosure is insufficient.

Citing the D.C. Circuit's 2010 ruling in American Equity Investors Life Insurance Co. v. SEC, they propose that an agency must consider whether "the existing regime" already provides "sufficient protections ... to enable investors to make informed investment decisions."[25]

Some argue that a broad, prescriptive approach across public companies — even those that are not major emitters of greenhouse gases in their operations — could alter the SEC's definition of investor demand.

It shifts the focus from a reasonable investor under the circumstances to a standardized requirement, overbroadly applied to all companies. This would not take into account what is reasonable under varying conditions that different public companies face.

On such record-based issues, the SEC has significant discretion, and will receive deference from reviewing courts. [26]

Moreover, as the D.C. Circuit articulated in National Association of Manufacturers, the SEC "is not required to 'measure the immeasurable,' and need not conduct a 'rigorous, quantitative economic analysis' unless the statute explicitly directs it do so."[27]

As in the earlier litigation challenging SEC's conflict mineral regulations, these may be difficult standards for challengers of new SEC regulations to overcome.

Additional Arguments

There are a number of other arguments that opponents of these disclosure requirements have raised, including that:

- Congress has already considered and rejected mandating similar disclosure requirements;
- There is a great deal of uncertainty about what the correct values, assumptions and scenarios for these climate-related financial disclosures should be; and
- The SEC has authority under existing law to punish those who are voluntarily providing false or misleading climate risk information. The SEC need not mandate such disclosures from companies whose managers conclude that their investors are not demanding them.

These points are likely to appear beside the prior constitutional, statutory and administrative procedural arguments.

Conclusion

In or shortly after October, the SEC will propose regulations mandating climate-related disclosures for public companies. But that is where the certainty ends.

Once the SEC promulgates final rules, legal challenges will follow. It could take years for those facial legal challenges to work through the federal courts.

Even thereafter, experienced regulatory defense counsel can be expected to assert these and other legal arguments in "as applied" challenges to the SEC's authority in enforcement actions.

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[1] Securities & Exchange Comm'n, Commission Guidance Regarding Disclosure Related to Climate Change (February 8, 2021), available at https://www.sec.gov/rules/interp/2010/33-9106.pdf.

[2] Jonathan Brightbill & Suzanne Jaffe Bloom, Executive Order on Climate-Related Financial Risks – Compliance and Risk Considerations, Winston & Strawn, Gov't Program Fraud, False Claims Act & Qui Tam Litig. Playbook (June 1, 2021).

[3] Office of Information and Regulatory Affairs Office of Management and Budget, SEC Climate Change Disclosure (June 17, 2021), available at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202104&RIN=3235-AM87; Dave Michaels, SEC Wants More Climate Disclosures. Businesses Are Preparing for a Fight, The Wall Street Journal (June 21, 2021), available at https://www.wsj.com/articles/climate-fight-brews-as-sec-moves-toward-mandate-for-risk-disclosure-11624267803.

[4] Public Input Welcomed on Climate Change Disclosures (Mar. 15, 2021), available at https://www.sec.gov/news/public-statement/lee-climate-change-disclosures.

[5] Jonathan Brightbill & Jennie Porter, An Early Look At What State AGs Want From ESG Disclosures, Law360 (Jul. 8, 2021), available at https://www.law360.com/articles/1401457.

[6] Prepared Remarks Before the Principles for Responsible Investment “Climate and Global Financial Markets” Webinar (July 28, 2021), available at https://www.sec.gov/news/speech/gensler-pri-2021-07-28.

[7] Id.

[8] Prepared Remarks Before the Principles for Responsible Investment “Climate and Global Financial Markets” Webinar (July 28, 2021), available at https://www.sec.gov/news/speech/gensler-pri-2021-07-28.

[9] Jonathan Brightbill & Jennie Porter, An Early Look At What State AGs Want From ESG Disclosures, Law360 (Jul. 8, 2021), available at https://www.law360.com/articles/1401457.

[10] Climate Change Disclosures at 6 (June 14, 2021), available at https://www.sec.gov/comments/climate-disclosure/cll12-8915606-244835.pdf.

[11] Competitive Enterprise Institute, Public Input Welcomed on Climate Change Disclosure (June 11, 2021) available at https://www.sec.gov/comments/climate-disclosure/cll12-8911811-244422.pdf.

[12] West Virginia State Bd. of Educ. v. Barnette, 319 U.S. 624, 642 (1943).

[13] Id.

[14] National Assoc. of Mfrs. v. Securities & Exchange Comm’n (“NAM I”) 748 F.3d 359 (2014), National Assoc. of Mfrs. v. Securities & Exchange Comm’n (“NAM II”), 800 F.3d 518 (2015).

[15] NAM II, 800 F.3d at 530.

[16] Id. at 531.

[17] NAM I, 748 F.3d at 368.

[18] 15 U.S.C. §78m(a).

[19] 17 C.F.R. §230.405.

[20] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449, (1976).

[21] See Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988) (materiality of information depends on whether the “impact” on a company’s “fortune” is “certain and clear” or “contingent and speculative”).

[22] Competitive Enterprise Institute, supra, n.11.

[23] NAM, 748 F.3d at 369-70.

[24] Id. at 369.

[25] American Equity Investors Life Insurance Co. v. SEC, 613 F.3d 166, 178-79 (D.C. Cir. 2010).

[26] NAM I, 748 F.3d at 366.

[27] Id. at 369.

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