THE U.S. SECURITIES AND EXCHANGE COMMISSION'S PROPOSAL FOR CORPORATE DISCLOSURE OF INFORMATION ON CLIMATE-RELATED FINANCIAL RISKS FACES LEGAL OPPOSITION

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Abstract: Humanity faces unique challenges due to climate change. The U.S. Securities and Exchange Commission (SEC) is recognized as the highest regulatory body in the United States with the authority to develop, adopt and promulgate legal rules relevant to the Institution's core mission of protecting the broad-based interests of investors, promoting market efficiency and competition, and fostering capital formation. On 21 March 2022, the Commission (SEC) proposed comprehensive and far-reaching guidelines for disclosure requirements for public companies regarding climate change and climate-related risks, both actual and potential. Based on many years of volunteer work by dedicated Commissioners, the SEC's Proposal affects both U.S. public companies and foreign private issuers. The Proposal, which is over 500 pages long, would require if adopted, covered public companies to disclose information about their greenhouse gas emissions and many other related issues. The purpose of this article is to review, analyze and discuss the challenges and strong legal opposition to the SEC's Proposal for mandatory corporate disclosure of climate-related risk information. The Proposal has generated discussion, heated debate, and disagreement, and opponents have raised valid arguments and considerations. Long before the Proposal was released, the debate over the SEC's authority (power, competence, and jurisdiction) was ignited, particularly from a legal perspective. This, in turn, cast a cloud over the newly proposed rules on climate-related issues. Moreover, in a letter to the SEC, professors, led by Lawrence A. Cunningham of George Washington University, expressed concern about the release and content of the Proposal, stating, "the passions of this topic [issue] have led the SEC to overzealous rulemaking that exceeds its authority". The methods employed by the author include a thorough examination of relevant literary sources, analysis and synthesis, induction and deduction, descriptive approach, observation, comparison, analogy, and others. The SEC's Proposal to establish rules for the disclosure of climate change risks has been the subject of extensive public comment, questioning, and deliberation. The SEC's asserted authority to regulate the emerging new area of climate change – a subject that some critics believe may be outside the scope of the SEC's mission and mandate – without additional Congressional authorization, has been the focus of considerable interest and exploration, criticism, analysis, and scrutiny. The SEC should consider and respond to any substantive arguments or information provided by public commenters in accordance with the general administrative law rules and procedures. The Agency may modify the provisions of the Proposal, under adoption, in response to comments, but it may not, without additional notice and discussion, make changes to the Proposal that are so significant that the public would not have had a reasonable opportunity to comment on the final rules. Significant legal challenges and litigation were expected to follow if the Proposal was adopted in its original, initial form, or any other form without substantial revision. Any legal challenge (objection) could take years to resolve in the federal courts. Even then, the conflict could persist and continue as long as defendants in SEC enforcement actions raise "as applied" arguments against the new rules. The SEC has extended the comment period to 17 June 2022 in light of "significant interest", particularly from the communities of investors, corporate officials, and issuers. However, due to a technical glitch, the SEC reopened the comment period in October 2022. In line with longstanding tradition and practice, the SEC was expected to analyze the comments before releasing the final guidelines for adoption. Despite the ongoing dynamic debate, in November 2022, the Commission published a new, updated Proposal to improve and standardize the rules on climate-related disclosures to investors. The Proposal of November 2022, if adopted, would, for the first time, require public companies to disclose their greenhouse gas emissions and, in some cases, to share this information with the reporting companies' suppliers and customers. Some public companies would be required to disclose additional information in their SEC filings about their long-term climate change strategies and ongoing initiatives to manage likely climate-related risks.
Keywords: climate change, climate-related risks, corporate disclosure, audited financial statements, materiality

1. INTRODUCTION

In April 2021, Gary Gensler took over as Chairman of the Securities and Exchange Commission (SEC), the nation's primary regulator, and identified climate change as being of the highest priority. Not surprisingly, on March 21, 2022, the U.S. Securities and Exchange Commission (SEC) proposed long-awaited rules that, if approved and adopted, would require extensive reporting by public companies on issues related to climate change disclosure, certification, and attestation (the "Proposal"). However, the SEC Commissioners were not unanimous, voting three

in favor and one against the Proposal to propose the long-awaited rules, with Commissioner Hester Peirce dissenting. Commissioner Peirce's statement, supra note three, highlights the potential confusion created by the Proposal's materiality thresholds for disclosure of Scope 3 emissions. Depending on which of the two events occurs later, comments on the Proposal were due 30 days after its publication in the Federal Register or on 20 May 2022 (i.e. 60 days after publication). Due to the high level of complexity of the subject matter of the Proposal and a large number of focal points and issues under discussion, as well as the substantial amount of information requested from commentators, it was reasonably expected that it was possible, indeed highly likely, that there would be requests for extensions to the comment period. Moreover, it was also noted that the SEC's recent practice of "short comment periods" in the rulemaking process has attracted Congressional attention. According to the latest data, the vast majority of the companies, surveyed by the SEC staff, do not currently consider the physical or transition risks associated with climate change to be material to their business operations and activities. Nevertheless, the SEC has proposed prescriptive rules as opposed to the principles-based disclosure requirements embodied in the concept and standards of materiality, because the Commission wanted to create the conditions for the provision of reliable and comparable information that is consistent with and tailored to the information needs of investors. The Proposal would require public companies to disclose information in registration statements and periodic reports on a wide range of topics, including:

- Climate-related risks and the actual or potential (probable) short, medium, or long-term manifestations of such risks that are currently having and/or could in the future have a material effect on the company's business activities, strategy, prospects, and financial statements;
- How the company manages climate-related risks, including methods for identifying, assessing, and controlling these risks, and whether any of these methods are included in its overall risk management system or methodologies;
- An appendix (note) to audited financial statements providing information on specific climate-related measures included in the financial statements;
- Detailed information on the goals, objectives, and targets related to climate change and on a transition strategy, if any;
- Direct and indirect greenhouse gas emissions (GHG) emissions, which would require third-party attestation reports for some emissions and accelerated and large accelerated filers. As mentioned above, large accelerated filers and accelerated filers would need to obtain an attestation report from a GHG attestation provider that includes disclosure of Scope 1 and Scope 2 emissions.

2. LITERARY SOURCES AND METHODS

The present article is based on a thorough research of the most recent scientific and normative sources relevant to its subject and focus, and the applied methods such as analysis and synthesis, induction and deduction, descriptive approach (method), observation, comparison, analogy, and others. Public comments and deliberations, considerations, and academic concerns following the SEC's proposal for disclosure rules on climate change that would affect public companies' corporate reporting and disclosure as a material component are systematically discussed.

3. CRITICISMS, DISPUTES, AND PUBLIC OBJECTIONS TO THE SEC'S PROPOSAL

Undeniably, the SEC's Proposal as a whole has been the subject of at least some criticism or disapproval. In March 2022, Patrick Morrisey, the Attorney General of the State of West Virginia, threatened to challenge the Commission, writing to the Agency that the State would take the agency to court on First Amendment grounds if the Agency pursued such a rule. The Cato Institute argued that proposals made by the Commission are "well beyond [the Agency's] authority and expertise" and "that alone is reason to abandon the course that the SEC has chosen", the Institute stated. In addition, Congressman Ted Budd, R-North Carolina, and other Republicans argued in a letter to the SEC that it is up to Congress to set policy on climate change. Congressional Republicans, Republican lawmakers, scientists, and academics have argued that the Securities and Exchange Commission (SEC) lacks the statutory and legal authority to require public companies to disclose information about climate-related financial risks. Opponents are laying the groundwork for a likely court challenge, arguing that the disclosure requirements would exceed the SEC's authority to regulate securities. However, the SEC, Democrats, and major investors dispute the claim that the disclosure rules would go beyond the SEC's authority to regulate securities and reject the Republicans' arguments. Professors of law and finance argue that the SEC's Proposal to require standardized information on targets relating to emissions reduction and other efforts to mitigate climate risk favours an influential group of institutional investors and environmental activists. However, such a policy on the part of the SEC does not do justice to the broader interests of diverse investors and the beneficiaries of all investors. Scholars argue that the

federal Clean Air Act delegates regulatory authority over climate disclosure to the EPA and that the EPA's authority likely preempts any legal authority the SEC might claim. In addition, the precedent has shown that Congress can be relied upon to take action on substantive, important issues such as climate change, which reduces the range of inferences of power on which the SEC can rely. In a letter dated April 26, 2022, the academics pointed out that "Governments, above all, must adhere to the rule of law, especially when officials believe honestly and fervently in a specific agenda". In addition, the academics emphasized that federal securities laws and regulations are overwhelmingly designed to protect investors, as they focus primarily on protecting the interests of investors. Nevertheless, the SEC's Proposal l prioritizes an influential subgroup's needs and demands, a part of the global investment industry. In general, academics are trying to encourage the Commission (SEC) to consider the interests of all American investors, "not just the most vocal and activist voices".

Appropriately, Gary Gensler, the current head of the SEC, highlighted a symptomatic fact. According to a Supreme Court ruling, which dates back to 1988, *"information is material if there is "a substantial likelihood that a reasonable shareholder would consider it important" in investment decisions*. Based on this legal fact, Gensler concluded that it effectively *"gives the SEC the green light to move forward with the rule"*. When there is such a great need for consistent, comparable information that can materially affect financial performance, the SEC has a responsibility and a role to play, Gensler believes. Thus, the demands of issuers on the one hand and investors on the other are driving the proposal, the Chair explained. Two areas, in particular, have attracted reactions of strong opposition from some people – the requirement generating the obligation to disclose emissions falling within Scope 3, and, secondly, the Commission's (SEC's) apparent elimination (removal) or revision of the qualifier regarding materiality in certain parts of the Proposal. Companies subject to the Proposal will be required to disclose information on three types of emissions:

- Emissions arising from sources that a reporting company directly owns or controls, which fall under Scope 1;
- Scope 2 includes emissions defined as "indirect" emissions, such as emissions caused by activities carried out by another company or party, for example, in the case of electricity generation purchased and consumed (used) by a reporting company; and
- Scope 3 comprises all other indirect emissions that occur in the value chain of the company, for example, all additional indirect emissions arising from sources that are neither under the company's ownership nor under the company's control and includes emissions arising from both upstream and downstream activities and goods.

All emissions produced by other companies, businesses, and organizations involved in the process that is necessary for the reporting company to produce or sell its product are included. Therefore, the Scope 1 and Scope 2 emissions of one company or organization are usually the Scope 3 emissions of another company or organization. Experts in the field support the view that compliance with the disclosure requirements designed for Scope 3 emissions could prove challenging and, as a result, issuers could incur significant costs. Significant resources may be required and expended to collect, quantify, and confirm the accuracy, correctness, and precision of the data required for Scope 3 due to the volume of information required and the risk of liability that companies may face for admitted inaccuracies in the disclosure data. In some cases, the risk of liability may be particularly high for disclosures relating to emissions falling under Scope 3, as reporting companies have no alternative (choice) but to trust and rely on data provided by sources that the companies do not produce or control. A company may be required (need) to disclose upstream emissions arising from acquired (purchased) commodities (raw materials, etc.) and capital goods, from fuel and energy-related activities, transportation and distribution activities, waste generated by operations, and even business travel, employee commuting, and asset leasing. Processing of sold products, end-of-life treatment of sold products, leased assets, franchises, and activities and operations on transport and distribution are all examples of downstream emissions that need to be disclosed.

Concerning the concept of materiality, some of the proposed disclosure requirements would eliminate the criteria for materiality (e.g. disclosure of Scope 1 and Scope 2 emissions), while, in other areas, it may prove difficult to distinguish material from immaterial environmental impacts. Generally, disclosure is required if the information is material to an investor, and information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision. Federal courts have tended to appeal to common sense: investors should be provided with the information they need to make the most informed decisions about where to invest, while it has often been the responsibility of issuers to determine the disclosure requirements addressed to them, including whether the information is material. Since immaterial information is, by definition, not important to investors, the question arises as to why companies should be required to disclose such information and, secondly, why the SEC is addressing the need for mandatory disclosure of such information to protect investors. This approach gives rise to sceptical or at least doubtful attitudes, which are exacerbated when

considering the pure relationship between the materiality of information and the relevance of the information to the financial return on investment.

4. THE MOST CHALLENGING COUNTER-ARGUMENTS SUPPORTED BY U.S. AUTHORITIES

Public authorities (U.S. Attorneys General, U.S. Senators, and other public officials) have raised concerns about the materiality standard (qualifier) associated with the mandatory reporting of Scope 3 emissions. The materiality qualifier for disclosure of Scope 3 emissions has been opposed for several key reasons, including that it presumes materiality determinations that should primarily be made by the reporting company, it creates significant disincentives to omit Scope 3 data, and it provides unclear, vague quantitative and qualitative metrics for when emissions may be material.

The SEC's authority to require disclosure of information that is not financially material was opposed by a large number of state attorneys general. These officials argued that existing SEC rules prohibiting the "misrepresentation of material information" do not provide an independent source. of authority for the Commission to require climate change disclosure, at least in the absence of evidence that it is necessary to prevent misleading or fraudulent statements.

There has been a very strong and immediate opposition response to the Proposal. Experts point to several potential grounds for a legal challenge, which can be further summarised as follows:

- The first thorny issue is whether the SEC has the statutory authority to adopt and promulgate mandatory climate change disclosure rules, as opponents argue that such rules are outside the scope and purpose prescribed by Congress;
- The new rules deal with important issues of climate change policy that should be decided by legitimate, duly elected legislators – members of the legislative branch, not by a single administrative agency with predominantly executive functions;
- The new rules compel speech in violation of the First Amendment; and
- The final rules (may) violate the Administrative Procedure Act as being arbitrary and capricious, according to the SEC's rationale for its conclusion.

In 2016, the SEC recognized that an explicit "congressional mandate" would be specifically required before the Commission could promulgate and adopt rules requiring disclosure of climate change risks and other information revealing environmental, social, and governance issues. However, there is no such congressional mandate. Therefore, the regulatory restrictions remain in place. A former commissioner appointed by the George W. Bush administration, Troy Paredes, suggested, "The goal of addressing climate risk as such is different from the goal of getting material information into the hands of investors so that they can make informed decisions about how to allocate capital".

5. CONCLUSION

A former SEC director, Meredith Cross, at present a partner at the law company Wilmer Hale, described the proposed rules as "the most extensive, comprehensive, and complicated disclosure initiative in decades". According to legal experts, the SEC's proposed rules on climate disclosure are expected to be finalised and adopted in their entirety (after being revised, improved, and refined) in late 2022 or early 2023. On 3 November 2021, the Trustees of the IFRS Foundation (London, 2021) announced the creation of a new standard-setting body – the International Sustainability Standards Board (ISSB). The SEC is also working with the new Board (ISSB) on a global set of climate-related disclosures to provide a universal standard that will form the basis of international financial reporting. These standards are also expected to be published in early 2023. Many large multinational companies are keeping an eye on the UK and the European Union (EU), both of which intend to introduce mandatory climate-related disclosures in the next 12 to 24 months, while the SEC's disclosures are in the sights of stakeholders.

Nevertheless, it remains symptomatic that the SEC's Proposal has sparked legal debate long before it was for the first time published, and this can be easily demonstrated. Does the U.S. Securities and Exchange Commission (SEC) have the legal authority to develop, formulate, adopt and promulgate rules requiring companies and corporate governance to disclose information on climate-related financial risks? This fundamental question remains in the United States and overseas. Congressional Republicans, Republican lawmakers, and academics point out that the Securities and Exchange Commission lacks the statutory, legal authority to require public companies to disclose information on climate-related financial risks. Former SEC commissioners stated the Agency (SEC) has a long way to go as it grapples with an outpouring of public comment on both sides of the problem. The SEC's newly proposed rules and requirements for climate-related disclosures represent a significant change from the previous rules, which have not been amended since 2010, as the guidelines have become much more complicated and complex and no longer rely solely on materiality criteria. As a result, the rules are likely to require significant line-item disclosure of

climate-related matters. The requirement for public companies to disclose climate-related exposures representing 1% or more of all line items in the relevant financial statements is just one of many measures to be considered. As a result, it is expected that boards of directors will need to redirect and devote much more time and resources to the C-suite, which is likely to require subject matter experts and deep expertise at all levels of the corporate function. The cost of preparing 'fit for purpose' reporting and disclosure and stakeholder engagement plans, strategies, and policies are likely to result in a significant increase in costs (expensed or capitalised) for many public companies, some of which are multinationals, that will be affected by the SEC's Proposal.

For investors and directors of companies operating in industries known to be major polluters, and for companies whose customers and suppliers are major emitters, climate risk considerations and concerns should be critical to their strategies, tactics, and policies. However, responsible climate policies promoted through regulation would always need to recognise and take into account the fact that the magnitude of such risks varies significantly across industries, companies, and business activities regardless of country or continent.

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