

# Clients & Friends Memo

## Made for TV: The SEC's Regulatory Posture on Climate Risk

March 1, 2022

***Warning: This article may describe new regulations that could upset the audience. Discretion advised.***

### Tonight's Episode

Climate change-related risks to the U.S. financial system are attracting increasing public attention in recent years and are raising questions about how U.S. financial regulators, including the U.S. Securities and Exchange Commission (the "SEC"), will address such risks. The SEC is on the precipice of issuing a proposed new rule regarding climate risk disclosures by public companies.

Although the attention being given to climate change financial risks is relatively new, the debate over the regulatory approach to climate change financial risks is merely the latest episode in a long-running series: A reality-TV contest pitting principles-based financial regulation against prescriptive financial regulation. The cast of characters: The SEC Commissioners, led by Chairman Gensler, a hard-charging Senator, idealistic environmentalists, and a billionaire fund manager. The theme for tonight's episode: Whether climate change risks are truly of material importance to investors, and whether the benefits to investors and issuers of making required disclosures will outweigh the costs of preparing such disclosures.

This article provides an overview of the current disclosure regime for climate risk. It also shines a spotlight on the dramatic debate taking place among the SEC Commissioners in the run up to the issuance of the proposed new rule. The article concludes with a preview for next week's episode by offering up predictions for what public companies and climate-conscious investors might expect to see when the new rule is proposed.

### Exposition: The Existing Disclosure Regime for Climate-Related Financial Risk

Generally speaking, public companies must disclose developments likely to have a material impact on the company, through annual or periodic reporting.<sup>1</sup> For example, registrants must "identify and

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<sup>1</sup> Rena S. Miller, Gary Shorter, & Nicole Vanatko (Feb. 17, 2022), *Climate Change Risk Disclosures and the Securities and Exchange Commission*, at 3 (CRS Report No. R4677) Retrieved from Congressional Research Service website: <https://crsreports.congress.gov/product/pdf/R/R46766> ("CRS").

disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial or operating performance.”<sup>2</sup> When it comes to determining what is “material”, under the “total mix” test laid down by the Supreme Court in *Basic Inc. v. Levinson*, a fact 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, or, put another way, if the information would alter the total mix of available information.”<sup>3</sup>

In 2010 the SEC published “Guidance Regarding Disclosure Related to Climate Change” (the “2010 Guidance”). The 2010 Guidance was an interpretative release intended to guide public companies on how to apply the SEC’s existing disclosure requirements to climate change matters.

The 2010 Guidance began by taking note of existing disclosure requirements such as those in Regulation S-K. For example, Item 101 of Regulation S-K expressly requires disclosure regarding certain costs of complying with environmental laws. Item 103 of Regulation S-K requires a registrant to briefly describe material pending legal proceedings, including those related to environmental litigation. Item 303 of Regulation S-K requires disclosure known as the Management’s Discussion and Analysis of Financial Condition and Results of Operations, or “MD&A”, which should provide material historical and prospective textual disclosure enabling investors to assess the financial condition and results of operations of the registrant. Item 503(c) of Regulation S-K requires a registrant to provide a discussion of the most significant factors that make an investment in the registrant speculative or risky.<sup>4</sup>

The 2010 Guidance went on to explain how these existing rules disclosure requirements might apply to climate change matters. For example, federal and state legislation relating to climate change might trigger disclosure requirements in various ways. Legislation regarding greenhouse gas emissions might trigger Item 101 disclosures if that legislation requires a registrant to expend material estimated capital expenditures for environmental control facilities. It might also trigger Item 303 MD&A disclosures if such expenditures would materially impact the registrant’s financial condition or results of operations.<sup>5</sup>

According to the 2010 Guidance, climate change might trigger disclosure requirements if the indirect consequences of climate change create material new business opportunities or risks. For example, if climate change creates market conditions more favorable for one type of energy

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<sup>2</sup> Commission Guidance Regarding Disclosure Related to Climate Change, Rel. No. 33-9,106 (Feb. 2, 2010) [75 FR 6290] (Feb. 8, 2010) (“2010 Guidance”) at pages 16-17 referencing Release No. 33-8056 (Jan. 22, 2002) [67 FR 3746].

<sup>3</sup> 2010 Guidance at page 11, referencing *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988), quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

<sup>4</sup> 2010 Guidance at pages 12-17.

<sup>5</sup> 2010 Guidance at page 22-23.

production or less favorable for another, a registrant involved in the energy industry might find it necessary to disclose that information in accordance with Item 303. The physical impacts associated with climate change might also trigger disclosure requirements. For example, it might be material for a particular registrant to disclose the risk of severe weather caused by climate change if the severe weather might affect the registrant's operations and results.<sup>6</sup> An owner, lender or investor with interests in coastal real estate, for example, may need to consider making such disclosures.

Near the end of his term in 2020, former SEC Chairman Clayton "summed up the prevailing approach to issuer disclosure of climate risks as requiring companies to provide appropriate and timely disclosure of known trends and other information that they deem to be material to a firm's future operations". He further noted that "such factors tended to be very company-specific and sector-specific".<sup>7</sup> Thus, the SEC's historical approach to climate risk disclosure, as embodied by the 2010 Guidance, has been very much a principles-based approach grounded in the principle of materiality. The advantage of the SEC's principles-based approach to disclosure is that it affords registrants some flexibility to disclose information that is material to their particular business and industry sector, and to omit immaterial information.

In September 2021, the SEC's Division of Corporate Finance issued a Sample Letter to Companies Regarding Climate Change Disclosures (the "Sample Letter") to provide further direction regarding climate-related disclosures.<sup>8</sup> The Sample Letter was issued in part due to the concern that many companies were seemingly not adhering to the 2010 Guidance in their disclosures.<sup>9</sup> In issuing the Sample Letter, the Division of Corporate Finance referenced the 2010 Guidance and cautioned that companies could expect to receive comments similar to those contained in the Sample Letter if they do not make adequate climate-related disclosures.

In the Sample Letter, the Division of Corporate Finance signaled that, consistent with the 2010 Guidance, a number of existing disclosure rules may require climate change-related disclosures. Depending on the circumstances, information related to climate change-related risks and opportunities may be necessary in disclosures related to a company's description of its business, legal proceedings, risk factors, and MD&A. Additionally, the Sample Letter stated that companies must disclose "such further material information, if any, as may be necessary to make the required

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<sup>6</sup> 2010 Guidance at pages 25-26.

<sup>7</sup> CRS at 7.

<sup>8</sup> SEC, *Sample Letter to Companies Regarding Climate Change Disclosure*, Sept. 28, 2021 (the "Sample Letter"), <https://www.sec.gov/corpfin/sample-letter-climate-change-disclosures>.

<sup>9</sup> CRS at 16 (Citing the Sample Letter).

statements, in light of the circumstances under which they were made, not misleading.”<sup>10</sup> Another comment from the Sample Letter directs issuers to identify material pending or existing climate change-related legislation, regulations, and international accords that may have a material effect on their businesses.<sup>11</sup> For example, companies with significant and concentrated exposure to commercial real estate may need to consider disclosing risks resulting from municipal laws regulating the energy efficiency and greenhouse gas emissions of buildings, including the risk of fines that non-compliant building owners could face until they successfully retrofit their buildings to comply with the applicable energy and emission benchmarks.<sup>12</sup> Similarly, companies with significant and concentrated exposure to automobile loan receivables may find it necessary to make disclosures regarding the financial impact of regulations that make the operation of gasoline-powered cars more costly with the resulting risks that such increased cost could cause loan payment defaults. Another comment from the Sample Letter directs issuers to identify any material physical effects of climate change on operations, including losses resulting from adverse weather changes.<sup>13</sup> For example, disclosures may be required for investment companies having substantial ownership interests in real property located in coastal regions. This may include disclosing risks associated with the physical effects of climate change on the investment company’s assets as well as indirect effects, such as more expensive property-casualty or flood insurance coverage.

In sum, the Sample Letter instructs public companies to consider revising or, in the absence of current disclosure, implementing climate-related disclosures regarding the impact of current or pending climate change-related legislation, regulation, or international accords, the indirect consequences of regulation or business trends regarding climate change-related risks, and the physical impacts of climate change.<sup>14</sup>

Few court cases have analyzed the federal securities law “materiality” standard in the context of climate change disclosures.<sup>15</sup> Two recent decisions have analyzed the materiality of Exxon Mobil Corporation’s disclosures and omissions regarding its “proxy cost of carbon”, a metric Exxon used to make predictions in its financial projections regarding the cost of potential government-related climate change actions.<sup>16</sup> In both cases, it was argued that Exxon’s public disclosures of its proxy

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<sup>10</sup> Sample Letter (Citing Rule 408 under the Securities Act of 1933 and Rule 12b-20 under the Securities Exchange Act of 1934).

<sup>11</sup> Sample Letter.

<sup>12</sup> See e.g. New York City Local Law 97.

<sup>13</sup> Sample Letter.

<sup>14</sup> *Id.*

<sup>15</sup> CRS at 10 (Citing *Hana V. Vizcarra*, *The Reasonable Investor and Climate-Related Information: Changing Expectations for Financial Disclosures*, ENVIRONMENTAL LAW REPORTER NEWS AND ANALYSIS (ELR), vol. 50, pp. 10106, 10112 (2020)).

<sup>16</sup> CRS at 10 (Citing *Ramirez v. Exxon Mobil Corp.*, 334 F. Supp. 3d 832, 846 (N.D. Tex. 2018); *People v. Exxon Mobil Corp.*, No. 452044/2018, 2019 WL 6795771 (N.Y. Sup. Ct. Dec. 10, 2019)).

cost of carbon were materially misleading because they differed from Exxon's internal costs estimates.<sup>17</sup>

In *Ramirez v. Exxon Mobil Corp.*, 334 F. Supp. 3d 832 (N.D. Tex. 2018), a U.S. District Court in Texas ruled that a "reasonable investor would likely find it significant that Exxon allegedly applied a lower proxy cost of carbon than it publicly disclosed" and that investors could have been materially misled because public statements made by Exxon indicated that only one proxy cost value was used across the company with investment considerations.<sup>18</sup> On the other hand, in a later New York State trial court case involving similar allegations, the court found that there was no proof that the use of different proxy costs of carbon affected Exxon's financial statements and that the subsequent disclosure of two differing costs was basically ignored by investors. Regarding materiality, the New York court ruled that, "no reasonable investor would have viewed speculative assumptions about hypothetical regulatory costs projected decades into the future as significantly altering the total mix of information made available."<sup>19</sup>

### **Rising Action: A Split Opens Among the Commissioners – A New, Prescriptive Approach to Climate Risk Financial Regulation**

A substantive split of opinion appears to have surfaced among the SEC Commissioners. Chairman Gensler and Commissioners Lee and Crenshaw are now publicly advocating for a more prescriptive approach to climate change disclosures to provide a "more uniform and standardized and less principles-based protocol."<sup>20</sup> In their view, the 2010 Guidance "did not result in high-quality disclosures of climate change risks across all U.S. publicly listed firms". Advocates for the new approach believe the existing disclosure regime "should be updated in light of global advancements over the preceding 10 years".<sup>21</sup>

In March 2021, Commissioner Lee, as Acting Chair, requested public input from market participants on whether current disclosures regarding climate change risks provided adequate information to investors (the "Request for Input"). The Request for Input included fifteen questions for consideration, including questions regarding how to quantify climate related data and what disadvantages result from different climate change reporting standards across different industries. In the Request for Input, Commissioner Lee also noted that she was asking the SEC's staff to analyze current disclosure rules with an eye toward facilitating consistent, comparable, and reliable

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<sup>17</sup> *Id.* at 10 (Citing *Ramirez*, 334 F. Supp. 3d. at 839-40, 846; *People*, 2019 WL 6795771, at \*4-5, 12-16).

<sup>18</sup> *Id.* at 10 (Citing *Ramirez*, 334 F. Supp. 3d at 846).

<sup>19</sup> *Id.* at 10 (Citing *People*, 2019 WL 6795771, at \*20).

<sup>20</sup> CRS at 7.

<sup>21</sup> CRS at 2.

disclosures relating to climate change risks.<sup>22</sup> The Request for Input is evidence of further momentum towards a more prescriptive approach to disclosure. As evidence of industry concern within the commercial real estate and structured finance markets, the Request for Input elicited comment letters from commercial real estate and structured finance trade associations such as the CRE Finance Council and the Structured Finance Association, as well as from influential asset managers such as BlackRock and Vanguard.<sup>23</sup> In October 2021, Chairman Gensler “commented that as part of the SEC’s forthcoming climate-change-related disclosure regime, he had asked SEC staff to consider a phased-in implementation approach for smaller versus larger public companies and tiered reporting time frames for different types of climate-related disclosures.”<sup>24</sup>

The Commissioners and Chairman Gensler are also debating what scope of emissions the new rule will require companies to disclose. The Commissioners are struggling to decide whether and how to require companies to disclose “Scope 3 emissions, which are mostly greenhouse gases produced by a company’s suppliers and by customers using its products.”<sup>25</sup> The Commissioners who are in favor of requiring Scope 3 disclosures argue that if Scope 3 disclosures are not required, the disclosed emissions would paint an “incomplete picture of a company’s impact” and “would allow companies to appear to reduce their carbon footprint by shifting emissions to their suppliers and customers.” On the other hand, those who are against requiring Scope 3 disclosures argue that the requirement would be too “onerous” and “burdensome,” especially on smaller companies, and that available data to a company isn’t always good enough to make accurate disclosures.<sup>26</sup> For example, in order to calculate Scope 3 emissions, a commercial real estate owner/operator might find it necessary to make numerous assumptions regarding its current and future tenants’ operations, as well as regarding the numerous inputs used in the construction and operation of their buildings.

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<sup>22</sup> Acting Chair Allison Herren Lee, *Public Input Welcomed on Climate Change Disclosures*, Mar. 15, 2021, <https://www.sec.gov/news/public-statement/lee-climate-change-disclosures>.

<sup>23</sup> Lisa Pendergast, *Public Input on Climate Change Disclosures*, CRE FINANCE COUNCIL (June 11, 2021) <https://www.sec.gov/comments/climate-disclosure/cll12-8906774-244142.pdf>, Michael Bright, *Public Input on Climate Change Disclosures*, STRUCTURED FINANCE ASSOCIATION (June 11, 2021) <https://www.sec.gov/comments/climate-disclosure/cll12-8911628-244370.pdf>, Sandra Boss, Paul Bodnar & Elizabeth Kent, *Request for Input on Climate Change Disclosure*, BLACKROCK (June 11, 2021) <https://www.sec.gov/comments/climate-disclosure/cll12-8906794-244146.pdf>, and John Galloway, *Public Input Welcomed on Climate Change Disclosures*, VANGUARD (June 11, 2021) <https://www.sec.gov/comments/climate-disclosure/cll12-8906800-244148.pdf>.

<sup>24</sup> CRS, at 8.

<sup>25</sup> Jean Eaglesham & Paul Kiernan, *Climate Disclosure Poses Thorny Questions for SEC as Rules Weighed*, THE WALL STREET JOURNAL, Feb. 18, 2022, <https://www.wsj.com/articles/climate-disclosure-poses-thorny-questions-for-sec-as-rules-weighed-11645180200>. Scope 1 and Scope 2 emissions include emissions from business operations and purchased energy.

<sup>26</sup> *Id.*



Even as they debate whether to require Scope 3 disclosures, some of the Commissioners are already bracing for the not-yet-proposed rule to face legal challenges. One potential basis for such litigation could be whether Scope 3 information is material. Another potential basis for legal challenge could be whether the benefits of the rule outweigh the compliance burden. Chairman Gensler instructed SEC lawyers that, to avoid a legal battle, their proposed rule must conform with the interpretation of materiality that has been laid out by the U.S. Supreme Court.<sup>27</sup> On the other hand, Commissioners Lee and Crenshaw take a very different view on how materiality should be assessed and argue that investors, not companies, should get to determine what is material.<sup>28</sup> Three-fourths of responses to SEC Commissioner Lee's request for input on climate-related disclosures advocated for mandatory climate disclosure rules.<sup>29</sup> BlackRock, led by billionaire fund manager and prominent ESG advocate Larry Fink, believes that mandatory climate-related disclosures "are in the issuers' as well as the investors' interests."<sup>30</sup> Senator Elizabeth Warren has even chimed in on the split that is delaying the proposed rule by sending a letter to Chairman Gensler on February 9, 2022 admonishing that "these ongoing delays are not acceptable" and demanding that a "clear timeline for publication" of the new rule be provided to her by February 23, 2022.<sup>31</sup> By contrast, Commissioner Peirce has been described as being opposed to the SEC climate disclosure efforts that are not centered on the materiality principle, because the increases in compliance costs that such disclosure requirements would cause would not be outweighed by "the offsetting benefit of material information".<sup>32</sup>

Already the SEC has taken some steps to move toward a prescriptive approach. In July 2021, Chairman Gensler stated that, "When it comes to climate risk disclosures, investors are raising their hands and asking regulators for more." Chairman Gensler argued that climate risk disclosures required in the future should be consistent and comparable because voluntary disclosures lead to a wide range of inconsistent disclosures. He also reasoned that mandatory disclosures would allow comparable criteria to be established among various companies with regard to climate risk. Additionally, Chairman Gensler proposed that disclosures should also be decision-useful so as to provide sufficient detail to enable investors to receive helpful information beyond generic text. As recommended by Chairman Gensler, decision-useful disclosures could include both qualitative and

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<sup>27</sup> Robert Schmidt & Benjamin Bain, *SEC Bogs Down on Climate Rule, Handing White House Fresh Setback*, BLOOMBERG, Feb. 8, 2022, <https://www.bloomberg.com/news/articles/2022-02-08/sec-bogs-down-on-climate-rule-saddling-biden-team-with-new-woe>.

<sup>28</sup> *Id.*

<sup>29</sup> CRS at 8 (Citing SEC Chairman Gary Gensler, *Prepared Remarks Before the Principles for Responsible Investment, "Climate and Global Financial Markets*, July 28, 2021, <https://www.sec.gov/news/speech/gensler-pri-2021-07-28>).

<sup>30</sup> See e.g. BlackRock Comment Letter—page 1, <https://www.sec.gov/comments/climate-disclosure/cll12-8906794-244146.pdf>.

<sup>31</sup> Letter from Senator Elizabeth Warren to Chairman Gensler—Dated Feb. 9, 2022, <https://www.sec.gov/comments/climate-disclosure/cll12-8911344-244296.pdf>.

<sup>32</sup> CRS at 9.

quantitative information regarding climate risk that investors rely on currently or desire to have in order to make investment decisions. Chairman Gensler also highlighted that companies could be required to provide scenario analyses on how a company might maneuver the potential physical, legal, market, and economic changes caused by climate-related risks in the future.<sup>33</sup>

Finally, Chairman Gensler expressed that funds labeling themselves with status identifiers such as “green” or “sustainable” need to disclose the criteria and underlying data used in achieving that status as such marketing measures are significant to investors.<sup>34</sup> The SEC created an ESG Task Force in 2021 to reexamine disclosures by ESG funds and analyze compliance issues relating to ESG strategies. The SEC stood up the ESG Task Force in light of increasing investor concern and reliance on climate and ESG-focused disclosure and investment. The initial goal of the ESG Task Force is to identify material gaps or misstatements in issuers’ disclosure of climate risks under existing rules. Additionally, the ESG Task Force will monitor disclosure and compliance with matters regarding investment advisers’ and ESG fund strategies. The ESG Task Force will use complex data analytics to combat potential misconduct, and will also analyze and pursue tips, referrals, and whistleblower complaints on ESG-related matters.<sup>35</sup>

### **Coming Up Next Week - Predictions about the Forthcoming SEC Proposal**

Having described the existing disclosure regime and the debate surrounding the pending rule proposal, this section offers predictions about the soon-to-be-proposed rule. It is apparent that the new proposal will likely adopt a prescriptive approach to climate risk disclosure, rather than a principles-based approach. The new prescriptive approach will likely leverage existing voluntary sustainability disclosure recommendations from standards-setting organizations such as the Task Force on Climate-Related Financial Disclosures (TCFD). It might even adopt industry-specific standards like those promulgated by the Sustainability Accounting Standards Board (SASB). Prominent asset managers such as BlackRock and Vanguard have thrown their weight behind that approach.<sup>36</sup>

Scope 1 and Scope 2 greenhouse gas emissions (emissions from business operations and purchased energy) will likely be required disclosure items.<sup>37</sup> When it comes to disclosure of Scope 3 emissions, it is more likely than not that such disclosures will not be required by the proposed new rule. If Scope 3 emissions disclosures are required, compliance will likely be

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<sup>33</sup> SEC, Gary Gensler, *Prepared Remarks Before the Principles for Responsible Investment “Climate and Global Financial Markets” Webinar*, July 28, 2021, <https://www.sec.gov/news/speech/gensler-pri-2021-07-28>.

<sup>34</sup> CRS at 8 (Gensler, *Supra*).

<sup>35</sup> See SEC, *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues*, Mar. 4, 2021, at <https://www.sec.gov/news/press-release/2021-42>.

<sup>36</sup> BlackRock Comment Letter; Vanguard Comment Letter, page 3.

<sup>37</sup> *E.g.*, Vanguard Comment Letter, page 3.



preceded by a lengthy phase-in period and accompanied by a legal safe-harbor from liability, as suggested in BlackRock's comment letter. The numerous difficulties and assumptions required to calculate Scope 3 emissions would likely mean that Scope 3 disclosures, if required, would not be reliable.

It remains to be seen to what extent the SEC's proposed new rule will draw inspiration from the European Union's Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulation.

The proposed rule might offer a phased-in implementation so that larger public companies will face earlier compliance deadlines, as suggested by Chairman Gensler in October 2021. In any event, public companies can be certain that compliance costs will likely increase. The demand for audit and assurance professionals and lawyers with skills and experience regarding climate change and ESG matters will likely increase.

### **Closing Credits**

The pressure is on for the SEC to prescribe standard disclosures regarding climate change. The SEC expressed concern, through guidance and statements in public forums, that many reporting companies have failed to observe the climate-related risk disclosure standards embodied in the 2010 Guidance. As a result, a majority of the Commissioners are in favor of proposing a new rule to implement a prescriptive approach to climate-related risks disclosures. Once finalized, these new disclosure rules will likely result in new reporting requirements that will increase compliance costs that reporting companies must bear. Although there are differences of opinion as to how climate change will affect investors and companies, one thing is for sure, regulatory change regarding climate-related disclosures is quickly approaching.

### **To be continued.**

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If you have any questions, please feel free to contact the following Cadwalader attorney.

Michael Ruder

+1 704 348 5303

michael.ruder@cwt.com