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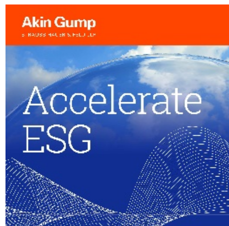

Ep. 4: SEC's Climate Disclosure Proposal: Part 2 – Potential Legal Challenges and Vulnerabilities

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Kenneth Markowitz: Hello and welcome back to Akin Gump's *Accelerate ESG* podcast, featuring in-depth conversations on a wide variety of ESG-related issues.

I'm Ken Markowitz, partner and co-lead of the firm's climate change group. Today, I'm joined by Stacey Mitchell, a co-leader of the firm's ESG [*environmental, social and governance*] and climate change practices, and Stephanie Lindemuth, a partner in the firm's litigation group. Welcome, Stacey and Stephanie.

Stacey Mitchell: Thanks, Ken. Great to be with you today.

Stephanie Lindemuth: Thanks, Ken.

Kenneth Markowitz: In March of this year, the SEC [*Securities and Exchange Commission*], in a three-to-one vote, proposed amendments to the agency's disclosure rules that, if adopted, would require public companies to provide certain climate-related information in their registration statements and annual reports.

As we discussed in an earlier podcast, these amendments are intended to enhance and standardize certain climate-related disclosures in response to demands by stakeholders for more consistent, comparable, reliable information regarding climate-related risks and impacts in supporting emissions disclosure. As we hit record to this broadcast, the SEC has not yet published a final version of the climate-related risk disclosure rule and reportedly may not do so before the end of Q1 2023.

In part one of this podcast series, we reviewed the content of the proposed disclosure rule, identified certain issues that merited particular attention by stakeholders, as well as potential intended and unintended

consequences of the SEC's proposal. We recommended some practical steps for companies to take now to prepare for compliance with the rule once it goes in effect.

At that time, we observed that the SEC unlikely would shelve the proposal but that various comments on the proposed rule could affect significantly the final form. For instance, we're hearing media reports now that suggest the originally proposed rules around Scope 3 greenhouse gas emissions may not be reflected in the SEC's final rule.

In the second part of this podcast series, Stephanie and Stacey will share some ideas around the legal challenges that the SEC will face regarding a final rule on climate disclosures. So, with that, let's get started.

Stacey, let's begin with some high-level thoughts regarding what are some of the legal challenges we can anticipate relative to the SEC's proposal. Where may the agency be vulnerable to legal attack?

Stacey Mitchell: At a 30,000-foot view, there are two main parts of the proposal that critics have been strongly opposing. The first, the Scope 3 emissions disclosure requirement, and the second, the SEC's elimination of the materiality qualifier in some areas of the proposal. As you mentioned in your introductory remarks, it seems critics were perhaps loud enough that the Scope 3 GHG emissions disclosure may have actually resolved itself in the context of comments. Of course, we won't know that until the final rule is published next year.

And as for eliminating the materiality qualifier, that's obviously controversial for a number of reasons, not the least of which is the fact that materiality has been the cornerstone of the SEC's disclosure framework and has, generally speaking, been used to determine when an investor or the market is entitled to information regarding a company's business or financial affairs. Many stakeholders, including one very vocal SEC Commissioner, questioned why the agency requires a company to disclose non-material information and whether such a requirement may in fact undermine investor protections.

That said, I think there are four legal challenges that certainly I expect to see shortly after the rule is finalized sometime in 2023. The first is that the SEC lacks the statutory authority to propose and implement the rule. The second, and I think it's closely tied to that same question, is whether the Supreme Court's decision in *West Virginia v. EPA*—which really raises the what's called the major questions doctrine—whether the rule can withstand that question, and then whether the rule is arbitrary and capricious. And then last but not least, whether it violates the First Amendment protections.

Kenneth Markowitz: Thanks, Stacey. That's a really good way to set the stage for the rest of this discussion.

Stephanie, do you mind spending a minute discussing the SEC's authority, and do you think the proposal goes beyond the SEC's statutory authority? And let's work through those potential legal challenges that Stacey just laid out.

Stephanie Lindemuth: Sure. In terms of the SEC's statutory authority, I think that it arguably does go beyond what the SEC has the authority to do. The Commission's present statutory mandate extends only to information material to informed investment and corporate suffrage decision-making. And Congress has not expanded the Commission's authority to issue climate disclosure rules in the intervening time. And actually, to the contrary, it has quite recently specifically rejected it.

That being said, Congress has mandated environmental report requirements with specificity and other contacts. For example, Congress authorized the EPA [*Environmental Protection Agency*] to mandate public disclosures of GHG [*greenhouse gas*] emissions as a part of its Greenhouse Gas Reporting Programs. Critics argue that the SEC lacks authority without similar clear statutory authority here.

In the climate disclosure rule context, we're looking more broadly at statutory authority under Section 7(a) of the Securities Act and Section 12(b) of the Exchange Act, which authorize the SEC to promulgate rules or regulations requiring disclosure of information that it believes is necessary or appropriate in the public interest or for the protection of investors. These mandatory disclosures are those required to protect investors from inflated prices and fraud, not just helpful for investors interested in companies that have corporate practices consistent with federally encouraged social views. Let me just quickly break down the proposal from an investor protection and public interest standpoint since that's where the statutory authority mentions and is derived.

In terms of investor protection, the SEC claims that it has broad authority to promulgate disclosure requirements that are "necessary or appropriate in the public interest or for the protection of investors." But the proposal here would require volumes of immaterial information. And critics argue that there's no connection between the proposal and protection of investors. And in terms of the public interest, the amount of complex information that would be disclosed would not necessarily be in the public interest because it would overload investors and obscure vital decision-making information.

The proposed rule does not work with the SEC's existing framework and historical scope of consideration. And under the existing SEC guidelines, companies must determine what information is material in their unique

circumstances and disclose those matters to investors. But under the proposed rule, companies seem to check off a list of issues that regulatory figures have predetermined as material. And within the proposed rule, the SEC is not merely asking companies to explain what they are doing, but is, instead, giving rigid suggestions on how a company might perform its internal tasks.

The SEC appears to be aiming to provide consistent, comparable, and reliable information about climate-related risks in response to purported investor demand. But the question here is, is that really material? And the market trends show that investors want this information anyways, but too much information could be overwhelming and counterproductive.

Some proponents of the composed rule argue that investors themselves have begun to demand voluntary climate risk disclosures from companies without the support of the SEC. And in this perspective, the proposed rule simply ensures that the data companies put out is not fraudulent. Under the status quo, for example, many companies post sustainability reports on their website. However, these reports are not geared directly toward investors, but instead target non-investor stakeholders.

Given that some investors demand additional disclosures and others demand that there be no additional disclosures, the SEC must have a reason to choose a side other than investor demand. But it's unclear why the SEC is siding with the investors who want additional disclosures. This decision to privilege certain investors over others appears to be or could be viewed as arbitrary and capricious under the Administrative Procedures Act [*APA*].

Kenneth Markowitz: Thanks, Stephanie. That's really helpful, putting everything into context around those four potential vulnerable legal challenges here.

I want to turn to the Supreme Court's decision in *West Virginia v. EPA* in which the court invoked the major questions doctrine. That decision has certainly been looming large in legal circles around Washington. And I'm hoping that, Stacey, you might be able to give us some insight on how that case may inform our thinking about the viability or vulnerability of the SEC's proposal.

Stacey Mitchell: Absolutely. Major questions doctrine was for the first time explicitly invoked in the *West Virginia v. EPA* decision that was issued on the last day of the Supreme Court's Term this June. And the doctrine directs courts to analyze whether Congress clearly authorized agency action in what it describes as extraordinary cases. And those cases are those which have vast economic or political significance.

The doctrine itself is founded on principles of separation of powers and a practical understanding of legislative intent. And this major questions

doctrine is a new substantive presumption that really overrides the ordinary statutory construction principles in these extraordinary cases.

When applying it, there's a two-step inquiry. First, does it trigger the major questions doctrine? And then if so, can the agency point to clear congressional authorization to regulate in the manner that it is proposing? The decision itself, the *West Virginia v. EPA* decision itself, sets forth several, although apparently non-exhaustive, considerations to help decide whether a case implicates the major questions doctrine.

And, so, to answer your question, Ken, whether this case is one that will implicate the major questions doctrine, I think this will certainly be raised by those that challenge this rule. And the question that the challengers will focus in on is one of the questions that was listed in the *West Virginia v. EPA* decision, which was whether the agency discovered in a long-extant statute an unheralded power that significantly expands or even transforms its regulatory authority.

No doubt challengers of this rule will turn and point to some of the points that Stephanie's just been making, which is that the SEC gets its regulatory instructions from the Securities Act of 1933 and 1934. And if the EPA cannot use Section 111(d) of the Clean Air Act to mandate cleaner energy, it's highly unlikely that the SEC can rely on the Securities Act of 1933 and '34 to regulate GHG emissions using this disclosure rulemaking scheme.

Federal security laws, it will be argued, reveal no congressional intent for the SEC to regulate GHG emissions. And certainly critics of the proposal have already, as soon as the major questions doctrine was announced over the summer have been pointing to that doctrine to say this SEC rule when finalized will fall victim to the major questions doctrine.

Kenneth Markowitz: Thanks, Stacey. Excellent analysis. I'm going to turn to Stephanie with that backdrop. If somehow the SEC climate disclosure proposal does survive the major questions doctrine as outlined in the *West Virginia* case, the legality of its climate disclosure proposal may hinge on whether it was arbitrary and capricious. Why is this standard important? And what sort of analytical framework would one use to think about whether or not the SEC's actions here in issuing the rulemaking was arbitrary and capricious?

Stephanie Lindemuth: Thanks, Ken. If the proposal were to get through the major questions doctrine that Stacey just walked through, then I believe you're correct that it would go to the arbitrary and capricious analysis under the APA. And under Section 706(2)(a) of the APA, it directs reviewing courts to invalidate agency actions that are arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.

And a decision is arbitrary and capricious if the agency, one, has relied on factors which Congress has not intended it to consider; two, entirely faila to consider an important aspect of the problem; three, offered an explanation for its decision that runs counter to the evidence before the agency; or four, has offered an explanation so implausible that it could not be ascribed to a difference in view or product of agency expertise.

The proposal we're discussing today has been described as one that follows the form of cost-benefit analysis expected of U.S. federal agencies, but the content of the proposed rule does not indicate thoughtful conception. It seems as though the SEC has not accurately considered the costs of conducting research for detailed disclosures versus the benefits an investor might gain from climate-related risk information. And there's ample precedent of courts abrogating SEC rules for failure to conduct an adequate cost-benefit analysis. And there are good reasons to doubt the sufficiency of that appearing in the proposal.

The SEC here is asking for highly granular information that is costly to obtain. And looking at the bigger picture, the proposed rule could drive companies into private equity over public markets, which is an idea that goes against the SEC's mission statement.

The SEC estimates that increased compliance burdens could be relatively small if companies already provide similar information. But this does not account for companies that do not currently provide similar climate-related risk information. And courts have vacated other SEC rules for failure to consider economic consequences.

The SEC must also consider whether the action will promote efficiency, competition, and capital formation. Opponents argue that the SEC has failed to articulate why the current principles-based system of climate-related disclosures does not already provide sufficient protections to enable investors to make informed decisions.

Kenneth Markowitz: Thanks, Stephanie. So we've got lots of tenets of administrative law here at play right now.

We're going to switch gears a little bit and look at one of the more novel arguments that we've seen. This argument focuses on whether or not the SEC's proposal infringes on First Amendment protections or constitutes compelled speech. And this is an argument that's gaining, at least piquing conversations. Stacey, I was wondering if you have any thoughts on this First Amendment infringement argument?

Stacey Mitchell: I think, Ken, it's indisputable that that question is going to be raised in this coming challenge. For certain, there will be arguments that the rule is compelling speech with respect to information that is either about internal operations of a company and/or subjective or disparaging. And certainly,

there is a string of cases dating back to the 1970s that suggests that compelling such speech is protected. The most recently we have seen is pertaining to conflict minerals in which companies were not. It was found that it was in violation of the First Amendment to compel companies to make statements with respect to their certain minerals being conflict-free.

And, so, I think absolutely we should look for this to be a challenge to the rule. And I think it will be an interesting argument. Again, the devil's in the details, and it will be relevant to what is ultimately required by the rule and what statements are required by the rule. But I think we should look for this challenge.

Kenneth Markowitz: Thanks, Stacey. I'm going to throw it out if either of you have any final remarks, but this has been an incredibly informative discussion and teeing up for our listeners today the potential legal challenges that we can anticipate to the SEC's climate disclosure rule probably in any form that it takes. So, Stacey, do you have a final comment?

Stacey Mitchell: Happy to jump in. I think one would be a fool to think that this rule or any other rule would not be challenged by opponents. It certainly is a wide-sweeping rule. There's been a substantial amount of controversy. Even those who have articulated support generally for the notion of climate disclosures filed very comprehensive comments to the rule suggesting that it took a step too far. And, really, I think even those that support this rule may ultimately challenge certain aspects of it. And, so, I look forward to reading the final rule and coming back here to discuss it further with you all perhaps in a third section of this podcast.

Kenneth Markowitz: Fantastic, Stacey. Thank you very much. Stephanie, any final thoughts for us today?

Stephanie Lindemuth: Sure. I certainly echo Stacey's comments. I think she's spot on. And I'm really glad that we got the chance to sit down together today to discuss these potential legal challenges because I think it's pretty obvious that some or all of these will be brought against the final rule. And I'm looking forward to seeing what the final rule actually will be and, as Stacey mentioned, an opportunity to sit down again to discuss it

Kenneth Markowitz: Stacey, Stephanie, it's been an absolute pleasure to be here with you today to discuss this. This is a wrap for part two of Akin Gump's *Accelerate ESG* podcast on the SEC's climate disclosure rule. Thanks again and have a good day.

Stacey Mitchell: Thank you, Ken.

Stephanie Lindemuth: Thanks, Ken.

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