4 Legal Challenges SEC's Climate Proposal Will Likely Face

By Jackie Vallette and Katie Gray (May 2, 2022)

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On March 21, the U.S. Securities and Exchange Commission voted 3-1 to propose new rules that would require public companies to, among other things, provide audited financial statements containing climate-related financial impact and expenditure metrics, report greenhouse gas emissions, and disclose details of how climate change is affecting their businesses.[1]

The proposal signifies a substantial change to existing law and, if adopted, would have wide-ranging implications for companies' disclosure requirements and internal procedures. As SEC Commissioner Hester Peirce described it in her dissenting statement, the proposal "turns the disclosure regime on its head."[2]

Opposition to the proposal has been swift and strong.[3] If the proposal is adopted as a final rule in its current or a substantially similar form, affected companies, trade associations or state officials are likely to challenge the new disclosure rules.

There are at least four potential bases on which legal challenges could be made:

- The SEC lacks statutory authority to adopt mandatory disclosure rules on climate change because such rules are outside the subject matters and purpose prescribed by Congress;
- The new rules involve major policy questions that should be decided by duly elected members of the legislature, not a single executive branch agency;
- The rules compel speech in violation of the First Amendment; and
- Depending on the SEC's explanation for its ultimate decision, the final rule is arbitrary and capricious under the Administrative Procedure Act.

1. The SEC lacks statutory authority to promulgate rules requiring climate-related disclosures.

Opponents of the proposal claim that rules requiring detailed and extensive disclosure of climate-related information exceed the SEC's statutory rulemaking authority.

As 16 state attorneys general argued in a letter to SEC Chair Gary Gensler in June 2021, the SEC's rulemaking powers must stay within the bounds of the purposes set forth in the SEC's enabling statutes, which "make clear that legitimate mandatory disclosures are those required to protect investors from inflated prices and fraud, not merely helpful for investors interested in companies with corporate practices consistent with federally encouraged social views."[4]

The Securities Act and the Securities Exchange Act authorize the SEC to promulgate rules or regulations requiring disclosure of information that the SEC believes is "necessary or appropriate in the public interest or for the protection of investors."[5] In making that determination, the SEC must consider, in addition to the protection of investors, "whether the action will promote efficiency, competition, and capital formation."[6]

The U.S. Supreme Court has "consistently held that the use of the words 'public interest' in a regulatory statute is not a broad license to promote the general public [welfare; rather], the words take meaning from the purposes of the regulatory legislation," according to its 1976 decision in NAACP v. Federal Power Commission.[7]

Thus, the SEC's authority to regulate in the public interest is not a concept without ascertainable criteria, and, as detailed below, there is a reasonable argument that statutory context, legislative history and other evidence of congressional intent authorize the SEC to require only disclosure of information that is material to the prospect of a company's financial returns.

First, the Securities Act and the Exchange Act limit the SEC's power to promulgate rules governing disclosure of specific types of information closely related to a company's value and prospects for financial success. Accordingly, Congress, with some exceptions, has restricted the subjects of mandatory disclosures to financial statements, core business information, directors and management, and a description of the securities.

Legislative history further suggests that Congress deliberately enumerated these categories of information for company disclosure and did not confer on the SEC unconfined authority to elicit any information whatsoever.

Rather, when Congress wished to later expand the subject matter of mandatory disclosures beyond financial matters, it specifically did so by statute, including for topics such as executive compensation, corporate governance and conflict minerals.

In 2016, the SEC itself acknowledged that "a specific congressional mandate" would be required before it adopted rules ordering climate change disclosures.[8]

In addition, Congress has mandated environmental reporting requirements with specificity in other contexts. Congress authorized the U.S. Environmental Protection Agency to collect reports from emission sources and make them available to the public, which resulted in the EPA implementing an annual reporting program that mandates public disclosure of GHG emissions.

Challengers of the proposal may seek to use this dichotomy of authority to argue that the SEC lacks, and cannot not act without, equally clear statutory authority.

2. The proposal exceeds the limits on regulation of major policy questions.

The "major questions" doctrine arose from the notion that important choices of social policy should be made by Congress.[9] An agency's exercise of regulatory authority over a major policy question requires a clear delegation of authority by Congress. Thus, litigants could invoke this doctrine to argue that, in the absence of a clear congressional command, the regulation of climate disclosures is too significant of a question to rest in the hands of a single Article I regulator like the SEC.

For courts reviewing legal challenges to the SEC's new climate-related disclosure requirements, one key question will be whether the SEC's rules regulate a major policy question of great economic and political importance. Expansive climate-related regulations that have never before been in the province or mandate of the SEC may well fit this criterion.[10]

Indeed, the nation's response to climate change and the topic of climate change disclosures presents major and contentious policy questions that are unresolved, including within Congress itself.

Assuming the proposal does involve a major policy question, it could be difficult for the SEC to argue that Congress has spoken clearly to confer on the SEC the authority to promulgate regulations requiring reporting of climate-related information. Congress granted the SEC regulatory authority to protect investors; facilitate capital formation; and maintain fair, orderly and efficient markets.

As Peirce pointed out, "Congress, however, did not give [the SEC] plenary authority over the economy and did not authorize [it] to adopt rules that are not consistent with applicable constitutional limitations."[11]

The proposal's opponents can point to recent Supreme Court precedents that invoke the "major questions" doctrine. Just three months ago, the Supreme Court held in National Federation of Independent Business v. Occupational Safety and Health Administration that a vaccine mandate issued by OSHA "significantly expand[ed] OSHA's regulatory authority without clear congressional authorization" and was thus unlawful.[12]

Similar challenges may be leveled against the SEC's new climate-related disclosure rules, which arguably expand disclosure requirements beyond the core principle of financial materiality that has animated SEC regulation from inception.

Moreover, legal challenges may be advanced through a related, albeit rarely invoked, constitutional separation-of-powers principle known as the nondelegation doctrine.[13] The Supreme Court has repeatedly held that Congress may authorize an agency to regulate in an area so long as it gives the agency an "intelligible principle" on which to base the regulations.[14]

The Supreme Court has not struck down a statute for violating that principle since the New Deal. However, several current justices have suggested that the U.S. Constitution places additional limits on Congress' power to authorize agencies to issue regulations.[15]

It is not clear what the additional limits would be. Nonetheless, litigants have invoked those statements to argue that congressional delegations of rulemaking authority are unconstitutional.

Proposal challengers likewise could argue that the statutory authority that the SEC invokes to promulgate the rule is an unconstitutional delegation of legislative power by Congress, and the proposal, therefore, is invalid. Although that argument is unlikely to prevail under the current nondelegation doctrine, this is an area to watch for potential developments in the law.

3. The proposal unconstitutionally compels speech.

Challengers of the new disclosure requirements also may invoke the First Amendment to argue that mandating environmental impact disclosures is unconstitutional compelled speech.

If public companies are required to comply with the SEC's proposed climate-related disclosure requirements, the argument goes, some companies would be forced to make remarks about their operations that are subjective or disparaging. This is something the First Amendment may protect against.

Some recent precedents suggest that a court reviewing the new disclosure rules may require the SEC to show (1) a substantial government interest that is (2) directly and materially advanced by the rules, and (3) that the rules are narrowly tailored.[16] Litigants would have potential arguments for each of these prongs.

First, opponents of the proposal could argue that compelling issuers to speak on information that is not material to financial performance is outside the SEC's core mission and that responding to public demand for increased information about companies' climate measures is not a sufficiently substantial governmental interest to compel such speech.[17]

Second, a great deal of uncertainty exists about the correct values, assumptions and scenarios for SEC's proposed climate-related disclosure requirements,[18] and therefore the resulting disclosures may be inaccurate or controversial, such that they cannot directly and materially advance any government interest that may exist.

Finally, litigants could argue that less restrictive means are available because they already exist, namely through materiality-based disclosure standards, other existing regulations[19] and peer comparability.[20]

Litigants may also draw parallels to the U.S. Court of Appeals for the D.C. Circuit's 2014 decision in National Association of Manufacturers v. SEC, which concluded that the First Amendment prevented the SEC from compelling companies to describe their products as not "DRC conflict free."[21]

The court found that the SEC's purported interest in adopting a forced disclosure regime to ameliorate the humanitarian crisis in the Congo rested on speculation and, therefore, the SEC could not demonstrate the adopted measure would "in fact alleviate" the harms recited "to a material degree."[22]

Accordingly, the court partially invalidated the conflict minerals disclosure requirement, a holding that could be used to support a legal challenge to the proposal.

4. The final rule is arbitrary and capricious under the Administrative Procedure Act.

If the SEC adopts the proposal as a final rule, another challenge could be that it is arbitrary and capricious in violation of the Administrative Procedure Act.[23]

Depending on the language of the final rule and the SEC's justifications for adopting the rule, challengers may argue that the SEC's underlying rationale or factual assertions are inconsistent, unsupported, unreasonable or fail to offer sufficient justification for choosing a given proposal over alternatives.[24]

If the reasoning in the final rule is similar to that in the proposal, challengers could argue that the SEC unreasonably concluded that the rule will generate comparable, consistent and reliable disclosures.

For example, industries may take issue with the SEC's estimates related to the cost of increased compliance burdens.[25] Courts have vacated other SEC rules under the APA for failure to adequately consider economic consequences.

In vacating the SEC's rule expanding proxy ballot access, for instance, in 2011 the D.C. Circuit found in Business Roundtable v. SEC that the SEC had

inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.[26]

Additionally, according to Title 15 of the U.S. Code, Section 77b(b), the SEC must consider "whether the action will promote efficiency, competition, and capital formation."[27]

Opponents of the proposal may argue that the SEC has failed to adequately articulate why the current principles-based system of climate-related disclosures — in which companies determine on a case-by-case basis whether a reasonable investor would consider the disclosure important — does not provide sufficient protections to enable investors to make informed decisions.[28]

Conclusion

We anticipate a heavy volume of comments on the proposal.[29] There is already intense interest in, and scrutiny of, the SEC's asserted authority to regulate climate change, a subject matter arguably outside its mission and mandate, without any additional congressional grant of authority.

Pursuant to standard administrative law principles and procedures, the SEC must consider and respond to any important arguments or data presented by public commenters.

Should the proposal eventually be adopted, significant litigation challenges will likely follow. It may take years for any facial legal challenges to work through the federal courts. Even then, the battle may continue as defendants in SEC enforcement proceedings assert "as applied" challenges to the new rules.

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[1] The Enhancement and Standardization of Climate-Related Disclosures for Investors, Release Nos. 33-11042;34-94478 (Mar. 21, 2022), https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

[2] Statement by Commissioner Hester M. Peirce, We are Not the Securities and Environment Commission – At Least Not Yet (Mar. 21, 2022), https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321 ("Peirce Statement").

[3] See, e.g., US Senator Joe Manchin III Letter to SEC Chairman Gary Gensler (Apr. 4, 2022), https://www.manchin.senate.gov/imo/media/doc/SEC%20ClimateDisclosure%20Letter.pdf?cb; Forty Congressional Members' Letter to SEC Secretary Vanessa A. Countryman (Apr. 11, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20123081-279409.pdf.

[4] Sixteen State Attorneys General Letter to SEC Chair Gary Gensler (June 14, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8915606-244835.pdf ("State Attorneys General Letter").

[5] Securities Act of 1933, 15 U.S.C. §§ 77a, et seq.; Securities Exchange Act of 1934, 15 U.S.C. §§ 78a, et seq.; see also 15 U.S.C. §§ 77g(a)(1), 78l(b)(1); see also id. § 78m(a).

[6] Id. §§ 77b(b), 78c(f); see also id. § 78w(a)(2). The SEC has interpreted its authority as cabined by its "core mission to promote investor protection, market efficiency and competition, and capital formation." Business and Financial Disclosure Required by Regulation S-K, 81 Fed. Reg. 23,916, 23,917, 23,922 & n.6 & n.55 (Apr. 22, 2016).

[7] NAACP v. FPC, 425 U.S. 662, 669 (1976).

[8] 81 Fed. Reg. at 23,970 & n.663.

[9] Indus. Union Dep't, AFL-CIO v. Am. Petr. Inst., 448 U.S. 607, 685 (1980) (Rehnquist, J., concurring) (major policy decisions must be made by Congress and the president in the legislative process, not delegated to agencies); Nat'l Fed. of Indep. Bus. v. OSHA, 142 S. Ct. 661 (2022).

[10] The Supreme Court's forthcoming decision in West Virginia v. EPA, No. 20-1530, involving the scope of the EPA's authority to regulate greenhouse gases, may inform how a reviewing court would treat a legal challenge to the SEC's climate disclosure rules. Questioning during oral argument, where the major questions doctrine was raised repeatedly, revealed a lack of clear consensus on what the doctrine requires. How the Court ultimately addresses this point could have broader impacts on federal agency regulation, including the legality of the SEC's new disclosure rules.

[11] Peirce Statement, supra note 3.

[12] Nat'l Fed. of Indep. Bus. v. OSHA, 142 S. Ct. 661, 665 (2022) (addressing a vaccine mandate that applied to roughly 84 million US workers, covering virtually all employers with at least 100 employees).

[13] See OSHA, 142 S. Ct. at 668-69 (Gorsuch, J. concurring) ("[T]he major questions doctrine is closely related to ... the nondelegation doctrine ... Both are designed to protect the separation of powers and ensure that any new laws governing the lives of Americans are subject to the robust democratic processes the Constitution demands.").

[14] See J.W. Hampton v. United States, 276 U.S. 394 (1928).

[15] See Gundy v. United States, 139 S. Ct. 2116 (2019); Paul, 140 S. Ct. at 342. In his dissenting opinion in Gundy, Justice Gorsuch, joined by Chief Justice Roberts and Justice Thomas, called for the Court to revive the nondelegation doctrine, criticizing current principles that allow for congressional delegation. Gundy, 139 S. Ct. at 2136-48. Concurring only in the plurality's judgment, Justice Alito concluded that, while he did not favor invalidation of the specific statute at issue in Gundy given the current legal standards, he would support an effort to reconsider the Court's approach to congressional delegation if a majority of the Court was so willing. While Justice Kavanaugh did not take part in consideration of Gundy, he has since foreshadowed that he would likely join Justices Gorsuch, Thomas, Alito, and Roberts in reviving the nondelegation doctrine. See Paul, 140 S. Ct. at 342 ("Justice Gorsuch's scholarly analysis of the Constitution's nondelegation doctrine in his Gundy dissent may warrant further consideration in future cases.").

[16] Central Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of New York, 447 U.S. 557, 564-66 (1980); see also Nat'l Ass'n of Mfrs. v. SEC, 800 F.3d 518, 521 (D.C. Cir. 2015) (NAM II) (applying Central Hudson's intermediate scrutiny to speech compelled by the SEC's prior conflict mineral disclosure rule).

[17] See, e.g., State Attorneys General Letter, supra note 5.

[18] Commissioner Peirce's dissenting statement highlights the potential confusion created by the Proposal's metrics for materiality in disclosing Scope 3 emissions. See Peirce Statement, supra note 3. The SEC's unproven methodology is in stark contrast to the uniform, collective judgments of a broad swath of securities professionals with differing views on ESG issues who have determined that statements regarding the quantity of direct or indirect GHG emissions are not material to investors' decisions. As certain opponents have flagged, a review of the 2020 Form 10-K annual reports of the Fortune 150 revealed that none of these reports included quantified metrics regarding the extent of issuer-associated GHG emissions, which is a strong indicator that such information is not necessary to protect investors who are considering securities purchases. See State Attorneys General Letter, supra note 5.

[19] See 40 C.F.R. §§ 98.1, et al. (EPA regulations governing "mandatory greenhouse gas (GHG) reporting requirements for owners and operators of certain facilities that directly emit GHG as well as for certain suppliers").

[20] See State Attorneys General Letter, supra note 5.

[21] Nat'l Ass'n of Mfrs. v. SEC (NAM1), 748 F.3d 359, 371 (D.C. Cir. 2014), overruled in part by Am. Meat Inst. v. U.S. Dep't of Agr., 760 F.3d 18 (D.C. Cir. 2014) (en banc). On rehearing, the NAM II panel reaffirmed its initial judgment in NAM I. See NAM II, 800 F.3d at 521.

[22] NAM II, 800 F.3d at 527.

[23] See 5 U.S.C. § 706(2).

[24] See Bus. Roundtable v. SEC, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011) (vacating SEC rule expanding proxy ballot access for shareholder-nominated board candidates for inadequate economic analysis); Am. Equity Invest. Life Ins. Co. v. SEC, 613 F.3d 166, 167-68 (D.C. Cir. 2010) (vacating SEC rule regarding fixed index annuities for failure to consider economic effects); Chamber of Commerce v. SEC, 412 F.3d 133, 136 (D.C. Cir. 2005) (vacating SEC rule regarding independent directors on investment company boards for

failure to consider costs and alternatives).

[25] See The Enhancement and Standardization of Climate-Related Disclosures for Investors, supra note 1, at p. 305.

[26] Bus. Roundtable, 647 F.3d at 1148-49.

[27] 15 U.S.C. § 77b(b) (providing that, for every rulemaking, the SEC "is required to consider or determine whether an action is necessary or appropriate in the public interest, ... [and] shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation").

[28] See US Senators' Letter to Chair Gary Gensler and Commissioner Allison Herren Lee (June 13, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8911330-244285.pdf ("US Senators Letter"); see also Am. Equity Invest. Life Ins., 613 F.3d at 178 (holding that "the SEC's analysis [was] incomplete because it fail[ed] to determine whether, under the existing regime, sufficient protections existed to enable investors to make informed investment decisions" and that the "failure to analyze the efficiency of the existing state law regime renders arbitrary and capricious the SEC's judgment that applying federal securities law would increase efficiency").

[29] Public comments to the Proposal are due by May 20, 2022 (60 days after issuance). The SEC received approximately 600 unique comments in response to then-Acting Chair Lee's request for public input on climate disclosures. Now, with approximately 500 pages of details crystallized in a formal proposed rule, we expect substantially more engagement. For context, when the Federal Communications Commission (FCC) opened up the public comment period on its proposal to roll back net neutrality rules, it received almost 22 million comments. If the Proposal elicits even a fraction of the comments the FCC's net neutrality rules received, the SEC's notice and comment process could easily take half a year.