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NEWS

Headed to Court? SEC's Proposed Climate-Disclosure Rules Will Likely Face Legal Challenge

Republican attorneys general say the environmental rules would exceed the agency's authority.

May 09, 2023 at 07:06 PM

Environmental Law

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Pending U.S. Securities and Exchange Commission climate-disclosure regulations have received a slew of criticism from Republican state attorneys general who say they will likely challenge the rules in court if promulgated.

In March 2022, the SEC announced it would propose rules requiring public companies to disclose climate-related risks and report their greenhouse gas emissions, including data on emissions generated by other entities in a company's supply chain. The proposal is often called the agency's environmental, social, and governance rule, or ESG.

Thomas Gorman, partner at Dorsey & Whitney, said the controversy begins with whether the SEC has the statutory authority to propose climate-related rules.

"There are people who think that the SEC has to stay with financial statements and nothing else," Gorman said. "I would expect that there will be suits challenging whether or not the SEC actually has authority to write rules in the area of the environment."

"In my personal view, the SEC should be able to write about anything that the company is really considering is material to the shareholder value," Gorman added. "That's what their job is. So if that's the environment today, then people want to know about it."

Under its proposed rules, the SEC would require companies to report any climate-related risks and disclose information on a company's direct greenhouse gas emission (Scope 1) and its indirect gas emissions (Scope 2). The proposal would also require a company to report greenhouse gas emissions generated by other entities in the supply chain (Scope 3).

SEC Chair Gary Gensler stated in March 2022 that the rule, “if adopted, it would provide investors with consistent, comparable, and decision-useful information for making their investment decisions, and it would provide consistent and clear reporting obligations for issuers.”

However, the rules have received much criticism from GOP state attorneys general. Last July, 24 of them—including those from Arizona, Alabama, Florida, Utah and West Virginia—sent a letter to the SEC, saying it lacks authority to implement the rules.

“Environmental regulation is outside the Commission’s area of expertise; if anything, the Commission is even less equipped to regulate in areas concerning climate change than EPA,” the letter stated, referring to the U.S. Environmental Protection Agency. “Yet the Commission can point to no congressional authorization other than statutes concerning investor ‘protection’ or the ‘public interest.’”

The state officials noted they would pursue legal action if or when the rule is finalized, adding that “we urge you to save everyone years of strife by abandoning the proposed rule.”

On Wednesday, Utah Attorney General Sean Reyes and Alabama Attorney General Steve Marshall are set to testify at a U.S. House Oversight and Accountability committee hearing on “ESG Part I: An Examination of Environmental, Social, and Governance Practices with Attorneys General.”

Heidi Friedman, a partner at Thompson Hine and co-chair of the firm’s ESG Collaborative, said the proposal would be a “fairly significant deviation” from public companies going from no regulation to potentially significant regulation.

“In terms of the state landscape, which is focused on the hearings right now, it’s a very interesting mix,” Friedman said. “ESG, which is really about aligning a company’s values with goals that will reduce its risks, help the world, all of those things, but bring financial value to its investors, employees, and other stakeholders, has become a very politicized issue.”

Meanwhile, regarding the proposed disclosure rules, scope three would be the most challenging to report, Friedman noted, because it requires companies to provide data on the greenhouse gas emission of every entity that is part of the company’s supply chain.

“It’s pretty easy to figure out how much energy you’re using either directly at your facilities or getting from your direct suppliers in terms of energy being supplied under scope one and scope two,” Friedman said. “If you are a large Fortune 500 company, I can’t imagine the number of individuals you need to help with that.”

Jurgita Ashley, also a Thompson Hine partner and another co-chair at its ESG Collaborative, said there is a Greenhouse Gas Emission Protocol guide on how to calculate those emissions, but it’s different from calculating it in the SEC’s proposed rules.

“There is no set standard or there is no set methodology,” Ashley said. “It is just expensive and sort of impractical.”

The Thompson Hine law firm conducted a survey last year asking public companies if they are preparing for the SEC climate-disclosure rules. The survey showed that 79% of companies are already undergoing preparations for when the rule is implemented.

The SEC’s climate disclosure rules were expected to be finalized in April but are still pending.

The delay might be that the SEC is trying to “design a rule that would withstand the judicial challenge that I think at this point … it’s inevitable,” Ashley said. “If scope three is included, there will be a challenge. If scope three is not included, there will be a challenge.”

Shawn Cobb, a partner at Allen Matkins, said that, generally, he is witnessing broad support for ESG from businesses.

“Frankly, there are a lot of industrial manufacturers in the United States that feel like they get a bit of a bad rap when it comes to publicity and public relations on this front,” Cobb said. “This is an opportunity for them to show that they really do work hard at environmental compliance.”

Sarah Fortt and Betty Huber, partners at Latham & Watkins and global co-chairs of the firm’s environmental, social and governance practice, stated in an email Tuesday that “2023 is likely to be a crucial year in the global conversations regarding ESG matters.”

“With respect to the SEC’s disclosure regulation specifically, we think it is fair to say that the issuance of the final rules will be the beginning, not the end, of a conversation regarding the role of climate-related disclosure regulation in the U.S.,” they wrote.

“Ultimately, ESG factors are likely to increasingly find their way into capital decisions, private contracting and litigation and dispute resolution, and in boardroom discussions,” Fortt and Huber added.

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