Testimony on “Beyond Scope: How the SEC’s Climate Rule Threatens American Markets”

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Before the
Committee on Financial Services
U.S. House of Representatives
April 10, 2024

Chairman McHenry, Ranking Member Waters and members of the Committee, thank you for the opportunity to testify today about the climate rules recently adopted by the U.S. Securities and Exchange Commission (SEC).[1] The rules were adopted by the SEC on March 6, 2024, pursuant to an adopting release of almost 900 pages, following a proposal of March 2022 that generated in excess of 24,000 comments.

A recent memo published by the law firm Cravath, Swaine & Moore, LLP called the rules perhaps the most controversial proposed rulemaking in SEC history.

Recent Federal Court Challenges to SEC Rulemaking.

A number of rules recently adopted by the SEC have been challenged in the federal courts and the SEC has suffered a number of setbacks in these cases.[2]

Proxy Rules. In June 2021, without seeking public comment, the SEC announced that it was suspending enforcement of the proxy rules passed in July 2020 during the term of former Chairman Clayton. Enactment of the 2020 proxy rules followed a 2010 concept release, proxy roundtables in 2013 and 2018, and a 2019 rule proposal. The National Association of Manufacturers (NAM) filed suit against the SEC challenging this suspension and in September 2022, the U.S. District Court of the Western District of Texas ruled for NAM, holding that the SEC did “not have the inherent power to stay or delay a final rule absent notice-and-comment rulemaking.”

In July 2022, the SEC adopted rules rescinding portions of the 2020 proxy rules passed during the term of former Chairman Clayton and NAM filed suit challenging the 2022 rulemaking as a violation of the Administrative Procedure Act (APA). In December 2022, the U.S. District Court for the Western District of Texas granted summary judgment in favor of the SEC. NAM appealed this decision to the Fifth Circuit and in December 2023, a three-judge panel of the Fifth Circuit heard the appeal. A memo on the hearing issued by the law firm Cooley summarized the hearing as follows: “Let’s just say that the Court didn’t appear to be particularly sympathetic to the SEC’s case, with Judge

[1] The views expressed in this testimony are my own and do not necessarily represent the views of my current employer Willkie Farr & Gallagher LLP.
[2] Many of these challenges were heard in the U.S. Court of Appeals for the Fifth Circuit.

Edith Jones mocking the SEC's concern with the purported burdens on proxy advisors as 'pearl-clutching'."

In a separate action relating to a 2019 lawsuit against the SEC by Institutional Shareholder Services Inc. (ISS) (NAM intervened in the action on behalf of the SEC), the U.S. District Court for the District of Columbia recently granted summary judgment in favor of ISS. In a March 2024 opinion, the court held that the SEC acted contrary to law in its 2020 proxy rules (and an earlier 2019 interpretation) when it amended the definition of "solicit" and "solicitation" to include proxy voting advice for a fee. Note that the 2022 proxy rules passed by the SEC under Chairman Gensler took the same position as to this issue as the 2020 proxy rules.

Share Repurchase Rules. The SEC adopted its share repurchase rules in May 2023 and promptly thereafter the U.S. Chamber of Commerce (along with other petitioners) challenged the rules in the Fifth Circuit. In October 2023, the Fifth Circuit held that the "SEC acted arbitrarily and capriciously, in violation of the [APA], when it failed to respond to petitioners' comments and failed to conduct a proper cost-benefit analysis." The court provided the SEC 30 days to "show that opportunistic or improperly motivated buybacks are a genuine problem." The SEC subsequently advised the court that it was unable to address the deficiencies and the court vacated the rules.

Private Fund Adviser Rules. The SEC adopted its private fund adviser rules in August 2023. In September 2023, six industry groups filed a lawsuit in the Fifth Circuit challenging the rules. The main challenge is to the authority claimed by the SEC to adopt these rules. In February 2024, a three-judge panel of the Fifth Circuit heard oral arguments on challenges to the private fund adviser rules. Based on the oral arguments, it appears that the Fifth Circuit will likely issue a ruling unfavorable to the SEC.

Dealer Rules. In February 2024, the SEC adopted rules significantly broadening the definition of "dealer" under the federal securities laws. In March 2024, three industry groups filed a lawsuit in the U.S. District Court for the Northern District of Texas, challenging, among other things, the authority claimed by the SEC to adopt these rules. Oral argument has yet to commence.

Short Sale and Securities Lending Rules. In October 2023, the SEC adopted new short sale disclosure rules and, on the same day, also adopted new securities lending disclosure rules. In December 2023, three industry groups filed suit in the Fifth Circuit asking the court to invalidate the rules on the basis that the SEC exceeded its statutory authority and conducted a defective economic analysis, including by failing to consider the interconnectedness of the two rules. Oral argument has yet to commence.

Shareholder Proposal Action. A three-judge panel of the Fifth Circuit recently heard arguments in a case brought against the SEC relating to a no-action letter issued by the SEC staff allowing Kroger to exclude from its 2023 proxy statement an "anti-ESG" proposal. A decision from the panel is still pending.

"Jarkesy" Challenge to SEC Administrative Courts. In addition, in 2022 the Fifth Circuit also ruled against the SEC in the *Jarkesy* case relating to an enforcement action brought

by the SEC against Mr. Jarkesy in the SEC's administrative courts. The court held that (i) the SEC's in-house adjudication of the case violated Mr. Jarkesy's Seventh Amendment right to a jury trial, (ii) Congress unconstitutionally delegated legislative power to the SEC by failing to provide an intelligible principle by which the SEC would exercise the delegated power, and (iii) removal restrictions on SEC ALJs violate the Take Care Clause of the U.S. Constitution. The decision was appealed to the U.S. Supreme Court; the appeal was argued in November 2023 and a decision is pending.

Federal Court Challenges to the SEC Climate Rules.

As expected, litigation challenging the SEC climate rules ensued promptly after the climate rules were adopted. Petitions were filed in the Fifth Circuit by Liberty Energy Inc. (Liberty) and other business groups and on March 15, 2024, the Fifth Circuit granted an administrative stay of the climate rules.

When petitions for judicial review of agency orders are pending in multiple circuits, the federal rules provide that a lottery system will be used to determine which Circuit Court will hear the consolidated cases. Before the SEC climate rules were adopted, rumors were circulating that filings would be made by interested parties in multiple Circuit Courts in the hope that the lottery system would move the legal challenges outside the Fifth Circuit.

After the climate rules were adopted, petitions were filed by environmental groups in the Second and D.C. Circuits. Neither of these petitions contained any legal arguments but in a press release one environmental group noted the basis of the action would be that the final rule "will yield much less information about companies' exposure to climate-based risks than the proposed rule would have." It was recently reported that Democratic attorneys general from 18 states and the District of Columbia are also looking to join the litigation in support of the climate rules.

In addition, various states also filed petitions in the Sixth, Eighth and Eleventh Circuits. In total, 25 Republican state attorneys general filed petitions. The lottery system ended up selecting the Eighth Circuit to hear the consolidated cases and the Fifth Circuit subsequently dropped its administrative stay of the climate rules. Liberty then requested that the Eighth Circuit grant a similar stay.

On April 4, 2024, the SEC issued an order staying the climate rules pending the outcome of the litigation in the Eighth Circuit. In its order, the SEC noted that it decided to voluntarily stay the rules to facilitate the orderly resolution of the legal challenges and to avoid companies being subject to the rules during the pendency of the litigation.

Overview of Legal Challenges to the Climate Rules.

The motion for an administrative stay filed in the Fifth Circuit by Liberty asserts that the climate rules violate the major questions doctrine, violate the APA as the rulemaking is arbitrary and capricious, and violate the First Amendment. I will address each of these challenges in turn.

The Major Questions Doctrine.

In 2015, the Environmental Protection Agency (EPA) promulgated the Clean Power Plan rule, which addressed carbon dioxide emissions from existing coal- and natural-gas-fired power plants and which provided for capping of carbon dioxide emissions at a level that would force a nationwide transition away from the use of coal to generate electricity. For authority, the EPA cited a section of the Clean Air Act, which section the EPA had only used a handful of times since its enactment in 1970.

Litigation commenced challenging the Clean Power Plan rule, which litigation eventually reached the U.S. Supreme Court. In 2022 in *West Virginia v. Environmental Protection Agency*, the U.S. Supreme Court concluded that Congress did not grant the EPA in such section of the Clean Air Act the authority to devise emission caps based on the generation shifting approach the EPA took in the Clean Power Plan rule. In reaching this conclusion, the Court noted that there are extraordinary cases in which the history and breadth of the authority the agency has asserted, and the economic and political significance of that assertion, provide a reason to hesitate before concluding that Congress meant to confer such authority. Under this body of law, known as the major questions doctrine, given both separation of powers principles and a practical understanding of legislative intent, the agency must point to a clear congressional authorization for the authority it claims. The Court also noted that Congress had conspicuously and repeatedly declined to enact a similar regulatory program.

The concurrence of Justices Gorsuch and Alito also stressed that the major questions doctrine protects the Constitution's separation of powers, and that while lawmaking under the Constitution can be difficult, that is not by accident, and permitting Congress to divest its legislative power to the Executive Branch would "dash this whole scheme."

In my view, there is a strong basis for the Eighth Circuit and the U.S. Supreme Court to conclude that the SEC's climate rules violate the major questions doctrine.

Outside the SEC's Expertise. The SEC's (unlike the EPA's) environmental expertise falls somewhere between limited and nonexistent. The SEC's climate rules borrow extensively from recommendations from the Task Force on Climate-Related Financial Disclosure (TCFD) and the Greenhouse Gas Protocol (the GHG Protocol). However, (i) these bodies are international and have not been delegated authority by Congress or otherwise authorized by Congress to set climate policy or climate metrics and (ii) the SEC has no meaningful ability to assess the efficacy of their work.

The SEC adopting release provides that the reporting framework in the climate rules has structural elements, definitions, concepts and structural requirements similar to those recommended by the TCFD. The adopting release contains approximately 250 references to the TCFD. The TCFD was established by the Financial Stability Board and charged with developing a voluntary, consistent climate-related financial disclosures that would be useful to investors, lenders and insurance companies. The TCFD had 32 members and was mainly comprised of data users, data preparers from non-U.S. companies, and representatives of accounting firms and rating agencies. The TCFD issued its final report in 2017.

The GHG Protocol was created through a partnership between the World Resources Institute and the World Business Council for Sustainable Development, in an attempt to create a standardized greenhouse gas (GHG) accounting methodology. The GHG emissions quantification and reporting requirements set forth in the adopting release were based on the GHG Protocol, though the adopting release dropped most of the scope 3 reporting requirements. The adopting release contains approximately 50 references to the GHG Protocol.

Economic and Political Significance and Lack of Specific Authority. As noted earlier, a leading law firm called the climate rules perhaps the most controversial proposed rulemaking in SEC history. A recent memo from another leading law firm, Latham & Watkins, described the new climate rules as "a historic expansion of U.S. securities disclosure" that would significantly increase the complexity of public company reporting.

For authority for the climate rules, the SEC is relying on its general authorization to require registrants to disclose information that the SEC finds necessary or appropriate in the public interest or for the protection of investors. The SEC argues that the climate rules are just disclosure rules for the benefit of investors and thus the climate rules are well within the SEC's established authority. However, they are not just disclosure rules (see for example the requirements to hire a third-party attestation agent and to measure all GHG emissions). Moreover, the SEC already has disclosure rules that currently require a registrant to disclose all material environmental risks, and neither the proposing release nor the adopting release rigorously examines the adequacy of the existing disclosure rules. Rather than simply continuing to require a registrant to disclose all material environmental risks and continuing to enforce these obligations, the almost 900-page adopting release instead adopts an elaborate framework, requiring information on climate-related risks, transition plans, scenario analysis, transition and physical risks, internal carbon prices, carbon offsets, GHG emissions and methodology, and climate targets and goals. The climate rules also require firms to estimate the financial statement impacts of severe weather events and other natural conditions, to disclose board and management oversight of climate risks, and to hire an attestation provider, file attestation reports and provide disclosure of disagreements with attestation providers, among other topics.

The proposing release also contained requirements to measure and disclose scope 3 emissions, which would have entailed a company obtaining emissions information from each entity in its value chain (customers, suppliers, etc.), which would have indirectly instituted these obligations on private companies throughout the U.S. economy. While many of these requirements have been lessened, the obligation for a registrant to obtain scope 3 information will still be applicable to any registrant who has set climate goals or targets (publicly or privately) or who has a transition plan, which is defined broadly to mean a registrant's plan to reduce climate risks. In addition, a registrant is also required to disclose the actual and potential material impacts of any identified climate-related risks on its customers, suppliers and contractual counterparties.

The APA.

As described above, the SEC's share buyback rules were recently vacated in connection with a finding by the Fifth Circuit that the SEC acted arbitrarily and capriciously, in violation of the APA, when it failed to conduct a proper economic analysis and failed to "show that opportunistic or improperly motivated buybacks are a genuine problem."

Proper Economic Analysis. In determining whether the SEC conducted a proper economic analysis, one major complaint about the analysis in the proposing release was that the cost estimates were unrealistically low. The adopting release notes a survey of 263 public companies conducted in 2022; 79% of respondents asserted that the SEC underestimated the costs of compliance with the proposed rules. Two of the more costly requirements (scope 3 and the requirement to identify climate-related risks on each financial statement line item) were materially reduced and eliminated, respectively.

To determine its cost estimates for the adopting release, the SEC used cost estimates provided by commenters and costs estimates from other public sources. Many of these commenters could be viewed as interested parties, both in favor and against the climate rules. Based on these sources, the SEC concluded in the adopting release that annual direct compliance costs ranging from $197,000 to $739,000 would be spent to comply with the climate rules and that $500,000 of indirect costs would initially be incurred to comply.

SEC Commissioner Hester Peirce describes the costs of compliance as including payments to third-party climate consultants, assurance providers, internal and external counsel, and information technology professionals; legal liability related to the mandated disclosures; and the indirect costs of lost management time, board distraction and changes in company operations.

Existence of a Genuine Problem. Another major complaint raised against the economic analysis in the proposing release and in the adopting release is that the SEC failed to prove that the reasons cited for the climate rules were a genuine problem. A 2023 article by Professor S.P. Kothari from the Massachusetts Institute of Technology (he was the SEC's Chief Economist under former Chairman Clayton) and others concluded that (i) asserting "investors demand it" is "not sufficient to justify mandatory ESG disclosure," (ii) the SEC failed to offer examples of shareholder harm related to inadequate climate disclosure and (iii) the climate rules impose costs that conflict with the SEC's goals of fostering liquidity and capital formation by pushing firms from public markets and adding to financing costs.

In a 2022 survey by the Boston Consulting Group of portfolio managers from investment firms, climate and other environmental risks ranked tied for last place among the eleven ranked macro investment risks. These investment firms have in excess of $9 trillion in assets under management.

As noted in the adopting release, the SEC has required disclosure of certain environmental matters for the past 50 years. In 2010 the SEC issued guidance on how existing rules may require disclosure of material climate-related risks and their impacts on a registrant's business or financial condition. The 2010 guidance discusses existing SEC rules, such as those pertaining to a registrant's description of its business and legal proceedings, which require disclosure regarding, among other things, compliance with environmental laws. These disclosures are required to be based on the registrant's specific facts and circumstances. In March 2019, the Director of the SEC's Division of Corporation noted specific examples of how material climate-related issues might trigger the need for disclosures from filers, consistent with the 2010 guidance.

For decades, the staff of the Division of Corporation Finance has reviewed companies' disclosures, assessing their compliance with disclosure requirements under the federal securities laws, including as to environmental issues.

In 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement to develop initiatives to proactively identify ESG-related misconduct. The SEC's Division of Examinations' 2021 examination priorities included an "enhanced focus" on climate and ESG-related risks.

As noted in the adopting release, each facility that emits more than a certain amount of carbon dioxide emissions must report those direct emission to the EPA. The EPA estimates that this reporting covers 85% to 90% of all GHG emissions from over 8,000 facilities in the United States, and this information is publicly available. In the economic analysis set forth in the adopting release, the SEC noted this information source but did not discuss whether this information is being used by investors and, if so, how it is being used by investors.

As noted in the adopting release, 39% of registrants currently include a discussion of climate-related risks in the MD&A section in their annual reports, which percentage has increased from approximately 15% in 2016. Among the largest filers, 68% provided references to climate issues in their 2022 annual reports. Registrants in the oil and gas, electric services and mining industry have the highest intensity of disclosures. In addition, a recent study found that in 2020, 76% of S&P 500 firms provided a sustainability report further discussing environmental, social and governance issues.

Summary. While I expect the cost estimates set forth in the economic analysis will prove to be below actual costs, it may be difficult for the challengers to the climate rules to convince the Eighth Circuit or the U.S. Supreme Court to find an APA violation based on the cost side of the economic analysis. However, more of a basis exists for the courts to find a violation of the APA based on the limited additional benefits to investors given the SEC's current rules requiring disclosure of material environmental disclosure and efforts to enforce these rules and the lack of research showing investor harm.

I also believe that, for these same reasons, a reasonable basis exists for the Eighth Circuit and the U.S. Supreme Court to find an APA violation for failure to show the existence of a genuine problem.

First Amendment.

Disclosures compelled by the SEC are "commercial speech" and receive deferential review by courts only when they are factual and uncontroversial. In its motion for an administrative stay filed in the Fifth Circuit, Liberty argued that the climate rules do not meet this standard because the topic is politically charged, and the frameworks used are controversial. Sean Griffith, a professor of law at Fordham Law School, argued in a recent article hat the SEC climate rules are controversial, and thus should not be subject to deference, for three reasons: (i) they impose a political viewpoint (noting that combatting the climate crisis is in the platform of the Democratic party), (ii) they benefit one subgroup of investors (asset managers) at the expense of investors generally, and (iii) they implicitly redefine concepts such as investor protection.

Other legal scholars take a different view. Rebecca Tushnet of Harvard Law School believes that the mandated statements are factual and thus will be deemed to be noncontroversial. The SEC in its prior filing in the Fifth Circuit in opposition to Liberty's motion of an administrative stay, argues that the climate rules require the disclosure of factual, non-controversial information in the context of commercial speech and thus merit deferential review.

However, if the climate rules do not receive deferential review, the climate rules would be unlikely to withstand strict scrutiny as they are extremely unlikely to be found to be "narrowly tailored" to achieve a substantial government goal. While the SEC argues the opposite in its prior filing in the Fifth Circuit, one thing the new climate rules are not is "narrowly tailored."

First Amendment cases are extremely difficult to win against the SEC in connection with its disclosure program. However, if the U.S. Supreme Court set aside the climate rules based on First Amendment grounds, this decision would be potentially devastating to the SEC and would put substantial legal stress on many of its other ongoing reporting requirements.

I look forward to answering any questions you may have.