Climate disclosure rules and the financial investor: exploring the SEC's "single materiality" approach to rulemaking and the litigation challenges it must overcome while competing "double materiality" frameworks gain acceptance

July 2024

On March 6, 2024, the Securities and Exchange Commission ("SEC") adopted regulations by a 3-2 vote requiring certain companies to make disclosures of climate-related information in registration statements and other filings companies must provide to the SEC (the "Climate Disclosure Rules"). The Climate Disclosure Rules were presented in final form roughly two years after the SEC first released a proposed version of the rules.

Hessam Kalantar,
Kalantar Business Law Group

As for their substance, the Climate Disclosure Rules are expansive (extending over 250 pages of the Federal Register).[1] For the sake of simplicity, the rules can be grouped into five categories: (1) disclosures about climate-related risks that have or will likely have a material impact on the reporting entity's business; (2) information about metrics used concerning the company's transition plans, scenario analyses, internal carbon prices and climate-related targets; (3) information about the board's role in overseeing material climate risks; (4) information about Scope 1 and Scope 2 greenhouse gas emissions from purchased or acquired electricity, steam, heat or cooling if the company is a "large accelerated filer" or an "accelerated filer"; and (5) disclosures to be made in the company's audited financial statements describing how the company's financial condition has been impacted by severe weather events.[2]

As for whom the Climate Disclosure Rules apply to, these rules would have begun to apply to companies of different sizes on a staggered basis over several years. For example, large accelerated filers would be required to make disclosures about climate-related risks that have had or are reasonably likely to have a material impact on the registrant business's strategy, results of operations or financial condition for the 2025 financial year, and these registrants would need to make certain disclosures about greenhouse gas emissions for the 2026 financial year. By contrast, emerging growth companies[3] would be required to make disclosures about climate related risks that had or are reasonably likely to have a material impact on the registrant's business on and after the 2027 financial year, and these companies would generally be exempted from making disclosures about greenhouse gas emissions.

---

1 The Climate Disclosure Rules appearing in the Federal Register can be accessed here: <https://www.govinfo.gov/content/pkg/FR-2024-03-28/pdf/2024-05137.pdf>.

2 An "accelerated filer" is an issuer of securities that has an aggregate equity market value of $75 million or more, but less than $700 million; a "large accelerated filer" is an issuer of securities with an equity market value of $700 million or more.

3 "Emerging growth company" is defined as a company with "total annual gross revenues of less than $1,235,000,000 in its most recently completed fiscal year.

Immediately after the Climate Disclosure Rules were adopted, various parties including states, energy companies and other interested groups filed petitions in six federal circuits requesting that these appellate courts review or stay the new rules. The Fifth Circuit ultimately granted a stay of the Climate Disclosure Rules on March 15, though all cases were ultimately consolidated on March 21 to be heard on the merits by the Court of Appeals for the Eighth Circuit. Shortly thereafter, on April 4, the SEC issued a stay of its Climate Disclosure Rules pending judicial review. Petitioners filed a consolidated brief on June 21 and, as of today, litigation is ongoing in the Eighth Circuit.[4]

Some reasons the Climate Disclosure Rules are being challenged in the United States

The Climate Disclosure Rules are controversial in the United States for various reasons, not least of which is the view that the promulgation of these rules exceeds the scope of authority which had been delegated by Congress to the SEC. Apart from arguments presented by litigants challenging the Climate Disclosure Rules in circuit courts, dissenting SEC commissioners also published their own statements describing their reasons for objecting to the Climate Disclosure Rules.

In the United States' system of government, federal administrative agencies are creatures of statute and may only exercise powers that have been expressly delegated to them by the federal legislature—and only in accordance with the Administrative Procedure Act (the "APA"). There are several recent examples of federal courts setting aside agency rulemakings on grounds that those rules exceeded the scope of an agency's authority under its enabling statutes, such as the setting aside of the SEC's new "private fund rules" on the grounds that the relevant provisions of the Investment Advisers Act of 1940 did not authorize the SEC to promulgate these rules.[5]

There are, however, other bases on which challenges to the SEC's Climate Disclosure Rules have been made, beyond the assertion that promulgating these rules exceeds the scope of the agency's authority. Some of these other reasons have been advanced by dissenting SEC commissioners in their statements concerning the agency's adoption of the Climate Disclosure Rules.

First, Commissioner Mark T. Uyeda argued that the Climate Disclosure Rules are procedurally flawed: the volume of changes that had been made to the regulations during the two-year period between the SEC's publication of its proposed rules in 2022 and the adoption of the final version of the rules in March of this year would require a new proposal to be made under the APA's notice and comment procedures. Second, Commissioner Uyeda invoked the "major questions doctrine", which has been used to invalidate agency rulemakings concerning political or economic issues of national importance when rules are not based on clear authorization from Congress. A recent example of the major questions doctrine being applied followed an agency rule requiring employers with over 100 employees to ensure that all staff receive medical interventions during a pandemic.[6] In that case Justice Neil Gorsuch of the U.S. Supreme Court appealed to the major questions doctrine as a reason to set aside the rule: if "administrative agencies seek to regulate the daily lives and liberties of [84 million] Americans. . . they must at least be able to trace that power to a clear grant of authority from Congress."

---

4 State of Iowa v. SEC, No. 24-1522 (8th Cir. 2024).

5 The SEC argued in its brief that its enabling law allows it to enact rules requiring public companies to disclose "not just "balanced book" information ... but [also] information important to making informed investment and voting decisions" more broadly.

6 National Federation of Independent Businesses v. Occupational Safety and Health Administration, 95 U. S. ____ (2022).

As Commissioner Uyeda wrote in relation to the Climate Disclosure Rules, these disclosure obligations are "an extraordinary exercise of regulatory authority by the Commission [involving] an economically and politically significant policy decision" without express Congressional authorization.

Third, Commissioner Uyeda questioned why a *securities* regulator is seeking to impose *climate*-related disclosure obligations onto companies (instead of, for example, environmental regulators who would presumably be better equipped to address climate related concerns). Fourth, Commissioner Hester M. Peirce raised the concern that the Climate Disclosure Rules do not contain any limiting principle (to justify requiring the disclosure of climate-related information but not information about other issues that some investors may wish to consider when making individualized investment decisions). To this point, Commissioner Peirce wrote that "[a]ll reasonable investors value financial returns, but they may diverge on which non-economic considerations are important. . . Congress did not create [the SEC] to satisfy the wants of every investor, but to serve the interests of the objectively reasonable investor seeking a return on her capital."

Fifth, the Climate Disclosure Rules have been impugned on the basis of the related concept of materiality. As Commissioner Peirce argued in her dissenting statement, the Climate Disclosure Rules depart from what she referred to as the longstanding "principles-based" interpretation of materiality endorsed by the U.S. Supreme Court.

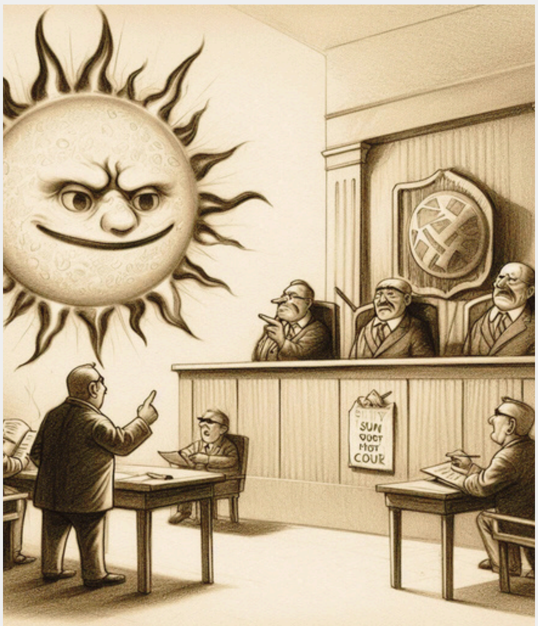
This interpretation of materiality (which has been called a "bedrock feature of American securities law") can be traced to the Court's decision in *TSC Industries Inc. v. Northway* (1976) where, instead of defining the concept with precision or crafting a bright-line rule to determine what information is material for purposes of federal securities law, the majority found that "the question of materiality. . . is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor." Rather than "burying investors in an avalanche of trivial information" or providing information that only *some* investors might consider significant, the concept of materiality requires companies to disclose information only if there is a substantial likelihood that a "reasonable investor" would consider the information important when deciding how to vote or make an investment decision. Since the 1970s, the concept of materiality with reference to what a "reasonable investor" would consider significant has been understood to include information impacting a company's financial situation only. Critics like Commissioner Peirce and petitioners in *Iowa v. SEC* argue that existing federal securities regulations already require companies to disclose climate-related information *if that information is financially material*, and that the Climate Disclosure Rules contort this framework by treating climate-related information as "uniquely important and thus material as a matter of law".

The rise of "double materiality" disclosure frameworks

As described above, the concept of materiality in U.S. securities regulation has centered on information "intended to present an objective picture of a company's financial situation" to investors. By contrast, the European Union's Corporate Sustainability Reporting Directive ("CSRD") and other frameworks developed by organizations like the Task Force on Climate-Related Financial Disclosures ("TCFD") have expressly endorsed "double materiality", a concept used for determining the kinds of information a company must disclose, encompassing both financial and non-financial information.

In fact, the innovations contained in the Climate Disclosure Rules were based in large part on the TCFD framework. Under double materiality, companies are required to disclose non-financial information about, for example, their environmental impact and sustainability efforts, direct and indirect carbon emissions, and corporate governance-related information. The TCFD and CSRD frameworks both reflect the double materiality concept of disclosure and are presented together as a major alternative to the financial materiality concept familiar to U.S. securities regulation.

The TCFD's recommendations, initially published in 2017, were essentially intended to serve as model rules that regulators may consult when producing their own climate-related disclosure rules. The framework centers on four "thematic areas that represent core elements of how organizations operate," including (1) governance, (2) strategy, (3) risk management, and (4) metrics and targets. Within each of these categories are specific disclosures that the TCFD encourages organizations across sectors to make. Alongside these recommended disclosures are two sets of guidance for providers of disclosures: one which is applicable to all organizations and a supplementary set for organizations operating in specific sectors.



The recommended disclosures can be summarized as follows. In the governance category, the TCFD recommends that organizations provide a description of management's oversight of climate-related risks and opportunities. As for strategy disclosures, the TCFD recommends that organizations describe climate-related risks and opportunities that the organization has identified over different time horizons, a description of the effect of climate-related risks and opportunities on the organization's business, strategy and financial planning, and a description of the "resilience" of the organization's strategies by performing scenario analysis using different climate-related hypotheticals. As for risk management disclosures, the TCFD recommends that organizations describe their processes for identifying, analyzing, and managing climate-related risks. For disclosures relating to the fourth category of metrics and targets, the TCFD recommends that organizations disclose the methods they employ to measure Scopes 1, 2 and 3 greenhouse gas emissions as well as climate-related risks and opportunities more broadly. Also within the metrics and targets category, organizations are encouraged to disclose information about their climate-related policy objectives and actual results from the implementation of these policies.

Unlike the TCFD's recommendations, the European Union's CSRD has the force of law (having become effective on January 1 of this year). Like the SEC's Climate Disclosure Rules, if they ever to come into effect, the CSRD will be phased in over time, beginning in January 2024 for certain large EU and EU-listed companies and, by 2028, for all companies under its scope. Companies under the CSRD's scope include (1) "large" EU entities or groups, (2) companies whose securities are denominated lower than €100,000 and which are listed on an EU regulated market, and (3) non-EU entities with "significant" EU revenues and an EU branch or subsidiary. As for its substance, the CSRD requires that disclosures embrace the "double materiality" concept broadly construed: in addition to requiring climate-related disclosures involving greenhouse gas emissions related to Scopes 1, 2, and 3, the CSRD obligates companies to disclose their "EU Taxonomy environmental objectives" (including climate change mitigation and adaptation efforts and their use of water and marine resources). The CSRD's broad scope also includes required disclosures about a company's management and business practices as they relate to social and human rights (as defined in United Nations and EU human rights conventions), sustainability efforts, and business ethics.

Conclusion

As of today, the SEC's Climate Disclosure Rules are not effective, and it is uncertain whether they will survive judicial review in the Eighth Circuit. Based on recent federal court decisions curtailing what many consider to be agency activism, the Eighth Circuit may ultimately vacate these rules. For now, however, Commissioner Peirce's 2020 remark that "[t]he European concept of "double materiality" has no analogue in our regulatory scheme" remains true. [7] Because the merits of climate and ESG disclosure rules will likely continue to be debated. Because regulatory uniformity among jurisdictions in this area seems unlikely), companies operating in multiple regions should be aware of the notable differences between conceptions of materiality held by local securities regulators and understand what these differences mean for their own disclosure obligations.

7 This quotation by Commissioner Peirce has been taken from "Statement by Commissioner Peirce on Rethinking Global ESG Metrics" (April 16, 2021).