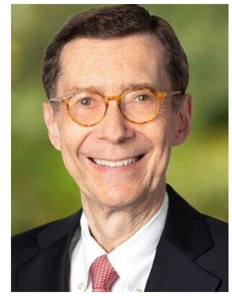
SEC's Proposed Climate Rules Are Problematic For Boards

By **Morton Pierce and Michelle Rutta** (November 10, 2022)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The U.S. Securities and Exchange Commission's proposed climate change disclosure rules, a 500-page landmark proposal requiring detailed disclosures relating to climate-related risks, greenhouse gas emissions and climate-related financial metrics, has many observers questioning the SEC's authority to effectively set climate policy, thus usurping the role of lawmakers.

Others have objected to the breadth of the required disclosure regarding greenhouse gas emissions, including indirect Scope 3 emissions of third parties — such as customers — from upstream and downstream activities in a company's value chain, if material or if included in emissions reduction targets. Tracking and disclosing such third-party information and analyzing its materiality will likely be complex and costly.

Another problematic aspect of the SEC's proposal is its likely impact on the oversight and governance practices of public company boards of directors and management teams in the area of climate-related risks. The proposal requires, among other things, an unprecedented level of detailed disclosures about companies' governance of climate-related risks and their process for identifying, assessing and managing such risks.

Under the proposal, governance-related required disclosures would include:

- The identity of each director and management team member responsible for climate risk oversight or management, and a detailed description of each such person's relevant expertise;

- A description of the board's process for discussing climate-related risks, including how the board is informed of these risks and how often board discussions of these risks are held;

- How the board considers these risks as part of its business strategy, risk management and financial oversight; and

- How the board sets climate-related targets or goals and oversees progress against them.

The proposed rules also require companies to identify the management positions or committees responsible for evaluating and managing climate-related risks, the processes by which managers are informed about and monitor these risks, the positions that report to the board on these matters, and how frequently these reports are given.

Risk management-related disclosures under the SEC proposal would include a description of the process for identifying, assessing and managing climate-related risks, including how the company:

- Determines the relative significance of the risks;
- Considers likely regulatory requirements;
- Considers shifts in customer or counterparty preferences, technological changes or market price changes;
- Determines materiality and how the potential scope and impact of each identified risk is assessed;
- Decides whether to mitigate, accept or adapt to each risk;
- Prioritizes whether to address the risks; and
- Determines to mitigate high priority risks.

Companies would have to describe how any such risk management processes are integrated into their overall risk management system, and how the board and management team interact on these risks.

In addition, if a company adopts a transition plan to reduce climate-related risks, such as a plan to reduce greenhouse gas emissions, such plan must be disclosed in detail, including the relevant targets and metrics used to identify and manage such risks.

The scope and level of detail required is a departure from typical SEC requirements, and delves deeply into the inner workings of the boardroom and the C-suite.

By mandating disclosure of such details as how board information is obtained, how many times various topics are discussed, how the board considers specific risks and determines specific policies, the processes through which management identifies, evaluates and mitigates climate-related risk, and the detailed expertise of those participating in discussions, the SEC is effectively attempting to use disclosure to dictate board and officer behavior.

These matters have traditionally been, and should continue to be, left to state law fiduciary duty principles.

If the proposed disclosure regime is adopted, conflicts with fiduciary duty principles could arise. Directors and officers could take actions which a court would find were sufficient to discharge their fiduciary duties. The SEC and the plaintiffs bar could attempt to enforce more stringent oversight or management through allegations of inadequate disclosure.

In addition, directors and officers may feel compelled to take actions and follow processes that they do not necessarily believe are warranted, or assess and address risks differently than they otherwise would.

Directors and officers may also feel compelled to interact with each other in the risk oversight area differently than they would choose to absent the SEC's disclosure mandate. Under state law, any of these actions could be found to be inappropriate and a breach of fiduciary duties.

These disclosure requirements can also be viewed as an attempt to intervene in the shareholder versus stakeholder debate and alter principles of state law fiduciary duties. These requirements raise the issue of how this type of disclosure is in the interests of promoting shareholder value.

It seems clear that this extensive disclosure will give environmental, social and corporate governance advocates and the SEC more information with which to criticize a company for inadequate disclosure and, indirectly, climate-related actions deemed inadequate. The benefits to shareholder value remain unclear.

As Vivek Ramaswamy pointed out in the Sept. 30 edition of the Wall Street Journal, certain investors claim that "ESG-promoting ... practices advance long term value creation ... and that 'how well companies navigate and adapt through the (climate) transition will have a direct impact on ... investment outcomes.'"

However, as Ramaswamy notes,

> If ESG promoting proposals truly enhanced long-run shareholder value, there would be no need for the Biden administration to create a new rule that would expressly permit retirement-fund managers to consider "collateral benefits other than investment returns" such as "climate change" when investing employees' money.

Under the SEC's proposal, in the area of climate-related risks, the principles-based reporting regime championed by the SEC in the past, which emphasizes the particular circumstances of each issuer and permits disclosure to be tailored accordingly, would effectively give way to a one-size-fits-all approach effectively dictating, in some respects, the breadth of appropriate board and managerial oversight and governance processes.

This could significantly affect current state law fiduciary duty principles.

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